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IN THE

Supreme Court of the United States

OCTOBER TERM, 1994

ALBERTSON'S, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether section 404 of the Internal Revenue Code bars the current deduction of interest accrued under a nonqualified deferred compensation plan.

2. Whether central heating, ventilating, and air-conditioning systems installed in supermarkets to meet the temperature and humidity requirements set by manufacturers of refrigerated food cases constitute "tangible personal property" within the meaning of section 48 of the Code.

THE PARTIES BELOW; CORPORATE AFFILIATES

Petitioner Albertson's, Inc., and respondent Commissioner of Internal Revenue are the only parties.

Petitioner has no corporate parent and no nonwholly-owned subsidiaries.

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PETITION FOR WRIT OF CERTIORARI

Albertson's, Inc., hereby petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit.

OPINIONS BELOW

The opinion of the court of appeals on rehearing (App. A) is reported at 42 F.3d 537. The initial opinion of the court of appeals (App. B) is reported at 38 F.3d 1046. The opinion of the Tax Court with respect to the deduction for interest (App. C) is reported at 95 T.C. 415. The opinion of the Tax Court with respect to the investment tax credit (App. D) is reported at 56 T.C.M. 928. The opinion of the Tax Court with respect to work incentive tax credits (App. E) is reported at 59 T.C.M. 186.

JURISDICTION

The judgments of the court of appeals were entered on December 30, 1993, and December 5, 1994. Timely petitions for rehearing were denied on February 2, 1995 (App. F). This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of sections 38, 48, 163, and 404 of the Internal Revenue Code of 1954, 26 U.S.C. §§ 38, 48, 163, and 404 (1982), of section 404 of the Internal Revenue Code of 1986, 26 U.S.C. § 404 (1994), and of Treas. Reg. § 1.48-1(e)(2), 26 C.F.R. § 1.48-1(e)(2) (1982), are set forth at App. G.

STATEMENT OF THE CASE

Petitioner Albertson's, Inc., operates several hundred retail food and drug stores throughout the western, mid-western, and southern regions of the United States. This federal income tax case relates to petitioner's taxable year ending February 3, 1983. Two separate and distinct questions are presented.

The first question is whether interest accrued in connection with a nonqualified deferred compensation plan may be currently deducted under section 163 of the Internal Revenue Code, 26 U.S.C. § 163 (1982) (unless otherwise noted, references herein to the Internal Revenue Code are to the 1954 Code as in effect during the taxable year at issue). In seeking rehearing below, respondent Commissioner of Internal Revenue candidly advised the Ninth Circuit that this question "is one of exceptional importance to the administration of the federal income tax laws." App. H at 101a.

The second question is whether supermarket heating, ventilating, and air-conditioning ("HVAC") systems constitute "tangible personal property" within the meaning of section 48 of the Code. In deciding this question

adversely to petitioner, the Ninth Circuit explicitly declined to follow the contrary holding of the Eleventh Circuit in *Piggly Wiggly Southern, Inc. v. Commissioner*, 803 F.2d 1572 (11th Cir. 1986). App. B at 40a n.25.

1. *Background.* The facts bearing upon the questions presented are as follows.

a. *Interest on deferred compensation.* Prior to the taxable year at issue in this case, petitioner established a voluntary deferred compensation plan for certain of its senior executives and directors. App. C at 42a. Under this plan, an eligible participant could elect to enter into a deferred compensation agreement and thereby defer receipt of a fixed amount or percentage of his salary or fees until retirement, termination of employment, or attainment of a specified age. *Id.*

Petitioner's deferred compensation plan was not funded. The deferred compensation agreements simply "represented the unsecured contractual obligations of petitioner to pay a specified sum . . . at or after a specified time." App. C at 42a. The amount of compensation thus deferred remained available to petitioner for use in its business as additional working capital or for other purposes. To reflect this fact, and in recognition of the time value of money, the agreements provided that upon payment of the deferred compensation petitioner also would pay "a further sum of money equal to the amount of interest accrued which shall be calculated by applying a rate of interest to the total accumulated amount of deferred compensation including accrued interest compounded monthly. The rate to be used will be the weighted average of [petitioner's] long term borrowing rate for that current fiscal year." *Id.* at 44a. (One of the agreements provided for a different rate of interest, measured by rates on large certificates of deposit. *Id.*)

This deferred compensation plan was not a "qualified plan" for purposes of section 401(a) of the Code. "Strict requirements must be met to achieve qualified

status. The most significant of these requirements relate to the funding of benefits, minimum coverage, prohibitions against discrimination, limitations on the benefits which may accrue to participants, and prohibitions against self-dealing. . . . An employer that contributes to a qualified plan must pay the contributions to a trustee under a trust arrangement or to an insurance company that issues an annuity contract with respect to the plan." App. C at 53a-54a.

An employer may take a current deduction for deferred compensation funded under a qualified plan even though the covered employees may not be required to include the compensation in gross income until they receive payment many years later. *See* App. C at 53a-54a. Pursuant to section 404(a)(5) of the Code, however, deferred compensation accrued under a nonqualified plan "shall not be deductible under section 162 (relating to trade or business expenses) or section 212 (relating to expenses for the production of income); but if they satisfy the conditions of either of such sections, they shall be deductible . . . in the taxable year in which an amount attributable to the contribution is includible in the gross income of employees participating in the plan."

Although section 163(a) of the Code grants a deduction for all interest paid or accrued during the taxable year, prior to 1982 petitioner had refrained from taking a current deduction for interest accrued under its deferred compensation plan, in effect treating that interest in the same manner as the deferred compensation itself. In 1982 petitioner requested permission from the Internal Revenue Service ("IRS") to deduct such accrued interest currently under section 163. App. C at 45a. The IRS granted the request. *Id.* "Relying on the permission granted," petitioner then deducted that interest for the taxable year here in issue. *Id.* "In 1987, the IRS changed its mind, however, and sought a deficiency." App. B at 28a. In defending this reversal of position, respondent has contended that the interest accrued under

petitioner's deferred compensation plan constituted "compensation" within the meaning of section 404 or, in the alternative, that section 404 by implication denies a current deduction not only for compensation but also for interest otherwise deductible under section 163.

b. *HVAC systems.* During the taxable year in issue petitioner purchased and installed HVAC systems in 33 new or remodeled food stores. App. D at 71a. "Each of the HVAC systems at issue consisted of a central air handler, compressor, condenser, cooling coils and heat reclaim coils, all of which were connected to a system of duct-work and diffusers. Petitioner's HVAC systems operated 24 hours a day, including hours its stores were closed to customers and employees." *Id.*

"[L]ike most food retailers," petitioner was required to install HVAC systems because of its use of open-front refrigerated food cases. App. D at 74a. Such food cases are designed "to operate properly in stores where temperature and relative humidity were strictly maintained according to certain specifications. All of the manufacturers' specifications for the cases used by petitioner recommended an ambient store environment at or below 75 degrees Fahrenheit and at or below 55 percent relative humidity." *Id.* at 72a. Permitting temperature and humidity to rise above these levels reduces shelf-life and can result in spoilage. *Id.* at 74a. "[T]he failure to use a HVAC system can easily result in lost product, sales and profits." *Id.*

Customers frequently find the required ambient conditions uncomfortable, but those conditions are dictated by the need to meet the temperature and humidity requirements of refrigerated food cases and thereby protect food against spoilage:

> [D]uring the summer months, the outdoor temperatures at the locations of petitioner's stores at issue would often reach or be in excess of 90 degrees Fahrenheit. The variance in petitioner's store temperature and the outdoor temperature created discomfort to

> many customers who complained to petitioner's employees that the stores were uncomfortably cold. Nevertheless, petitioner could not raise its store temperature to accommodate its customers without risking spoilage of its refrigerated food products displayed in open-front cases.

App. D at 74a.

Petitioner sought investment tax credits for its newly installed HVAC systems pursuant to section 38 of the Code. Respondent contested petitioner's entitlement to those credits. Their disagreement centered on "whether petitioner's HVAC systems . . . are tangible personal property within the meaning of section 48(a)(1)(A) and the regulations promulgated under that section." App. D at 76a. Under those regulations, "petitioner's HVAC systems are tangible personal property qualifying for the investment tax credit if they are not 'structural components.'" *Id.* at 77a.

The meaning of the regulatory term "structural components" is discussed as follows in Treas. Reg. § 1.48-1(e)(2) (1982), a legislative regulation that "has the full force and effect of law," App. D at 78a:

> The term 'structural components' includes such parts of a building as walls, partitions, floors, and ceilings, as well as any permanent coverings therefor such as panelling; windows and doors; all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts . . . . *However, the term 'structural components' does not include machinery the sole justification for the installation of which is the fact that such machinery is required to meet temperature or humidity requirements which are essential for the operation of other machinery or the processing of materials or foodstuffs. Machinery may meet the 'sole justification' test provided by the preceding sentence even though it incidentally provides for the comfort of employees, or serves, to an insubstantial degree, areas where such temperature or humidity requirements are not essential.* For ex-

> ample, an air conditioning and humidification system installed in a textile plant in order to maintain the temperature or humidity within a narrow optimum range which is critical in processing particular types of yarn or cloth is not included within the term 'structural components.'

Id. at 77a-78a (emphasis added by the court). The dispute between petitioner and respondent turned on whether petitioner's HVAC systems met the "sole justification" test propounded by this regulation.

2. *The Tax Court's decisions.* Following respondent's determination of a deficiency, petitioner filed a petition for review in the United States Tax Court pursuant to section 6213 of the 1986 Code. In separate opinions, the court held that petitioner was not entitled to deduct the interest accrued under its deferred compensation plan, App. C, but that petitioner was entitled to an investment tax credit for its HVAC systems, App. D. (In a third opinion, the court decided a question not presented here, involving work incentive tax credits. *See* App. E.)

a. *Interest deduction.* As the Ninth Circuit later observed, the Tax Court was "sharply divided" with respect to the deduction for interest accrued under the deferred compensation plan. App. B at 28a. The case was considered by the full court. Nine judges joined in a majority opinion holding that "[t]he 'interest' factor in petitioner's DCAs [deferred compensation agreements] is not interest within the meaning of section 163. Rather, it is part of the deferred compensation. It is therefore deductible only [when the employee receives payment]." App. C at 59a.

The majority took the position that "interest is a payment for the use of money that the lender had a legal right to possess, prior to relinquishing possession rights to the debtor." App. C at 48a. Noting that a deferred compensation agreement is executed before the partici-

pant has a legal right to receive the compensation, the majority reasoned that "Petitioner could not have 'borrowed' something from the DCA Participants that the DCA Participants never had the right to possess . . . [and therefore] Petitioner cannot properly characterize its accruals as 'interest.' " *Id.* at 50a.

This reasoning was rejected by four concurring judges and five dissenters. The concurring judges (one of whom also joined in the majority opinion) explained:

> [We] do not think that the case turns on whether the 'interest' component of the deferred compensation represents payments made by petitioner for the use of money 'borrowed' from its employees and director. A central focus of the time value of money legislation of the last ten years was to identify hidden interest. Congress clearly understood that transactions involving deferred payments for services contained an interest element. Thus, given our current understanding of the interest element inherent in deferred payment transactions, the majority's analysis seems anachronistic.

App. C at 61a (footnote omitted). These judges reasoned, however, that section 404, which bars the employer from taking a current deduction for compensation until the employee includes that compensation in income, by implication also bars the employer from taking a current deduction for interest: "If the employer were allowed an interest deduction, then the present discounted value of the tax burden on the employer would not be equivalent (i.e., would be less than) an immediate tax on the employee (assuming, of course, equal tax rates). We need not allow that result." *Id.* at 63a (footnote omitted).

The dissenting judges pointed out that " 'interest is . . . paid because of delay in the receipt of funds' . . . [and] it is obvious the additional amounts accrued under the DCA's were accrued because of delay in the receipt of funds." App. C at 65a, quoting *Aames v. Commissioner*, 94 T.C. 189, 193 (1990). The dissent continued:

> Having found the amounts in question are interest, the statute is clear: the deduction is not limited by sections 404(a)(5) and 404(d) . . . . In his concuring opinion, Judge Halpern argues that allowing an employer to deduct interest in advance of inclusion by employees frustrates the matching principle, but it is the prerogative of Congress, not this Court, to change the statutory result. . . .

Id. at 66a.

b. *Investment tax credit.* The Tax Court held that petitioner's installation of HVAC systems in its food stores met the regulatory "sole justification" test and thus qualified for the investment tax credit: "if [petitioner] did not maintain case manufacturers' specifications for store environment, whatever those specifications may be, the quality of its food products displayed in its open-front cases would suffer, resulting in lost product, sales, and profits. It was for this reason that it was crucial to the operation of each of petitioner's retail food stores that each had a HVAC system." App. D at 81a. Under the regulation, it made no difference that the HVAC systems also afforded an "incidental benefit to customers and employees." *Id.*

3. *The Ninth Circuit's initial decision.* The Ninth Circuit initially reversed the Tax Court on both issues.

a. *Interest deduction.* The Ninth Circuit determined that the Tax Court majority had erred in its analysis of what constitutes "interest" under section 163: "a legal right to possession of the assets on which the additional amounts are earned is not necessary in order for those earnings to qualify as interest. . . . The controlling principle [is] not possession, but rather 'compensation for the use or forbearance of money.' " App. B at 30a-31a, quoting *Starker v. United States*, 602 F.2d 1341, 1356 (9th Cir. 1979). Under that test, the court of appeals held, the accrued amounts were interest. In so holding, the court rejected respondent's argument that those

amounts represented not interest but additional deferred compensation, explaining that "[t]he predetermined rate for calculating the additional amounts did not depend in any way upon the amount or type of services performed by the participants." *Id.* at 31a.

The court next determined, "[b]ased on a plain-language reading of the statute," that section 404 does not bar the current deduction of interest accrued under a nonqualified deferred compensation plan. App. B at 33a. The court reasoned that section 404 on its face bars deductions only under sections 162 and 212; Congress could have extended the statute to reach interest deductions under section 163 as well, but it did not do so. "Because we must not 'add to or alter the words employed to effect a purpose which does not appear on the face of the statute,' *Hanover Bank v. Commissioner*, 369 U.S. 672, 687 (1962), we hold that . . . the timing restrictions of section 404 were inapplicable to interest deductions." *Id.* at 35a. This conclusion, the court believed, was confirmed by the legislative history, which "mentions only 'compensation.' . . . [T]here is no indication in the legislative history of section 404 that Congress intended it to apply to interest." *Id.*

b. *Investment tax credit.* The Ninth Circuit rejected the Tax Court's determination that petitioner's installation of HVAC systems in its food stores met the regulatory "sole justification" test because, according to the court of appeals, those systems serve "two additional significant purposes: ventilation and customer comfort." App. B at 38a. The court believed that the regulation's reference to comfort as an acceptable incidental benefit "applies only to *employees*." *Id.* at 39a (emphasis in original). Accordingly, the court expressly declined to follow *Piggly Wiggly Southern, Inc. v. Commissioner*, 803 F.2d 1572 (11th Cir. 1986), "in which the Eleventh Circuit held that costs for a similar HVAC system qualified for an investment tax credit." *Id.* at 40a n.25.

4. *The Ninth Circuit's decision on rehearing.* Respondent filed a petition for rehearing and suggestion for rehearing *en banc* asking the Ninth Circuit to reconsider its holding with respect to the current deductibility of interest under nonqualified deferred compensation plans. Respondent described this issue as "one of exceptional importance to the administration of the federal income tax laws" and stated that "if the panel's decision were to be applied nationwide, the reduction in federal tax receipts could total $7 billion from Fiscal Year 1994 through Fiscal Year 1999." App. H at 101a. The original panel thereupon granted rehearing and proceeded to "change[] our minds about the result we reached in our original opinion." App. A at 5a.

The court acknowledged that interest accrued under a nonqualified deferred compensation plan is currently deductible "under a literal reading of the statutory language." App. A at 16a. The court reasoned, however, that the purpose of section 404 is "to ensure matching of income inclusion and deduction between employee and employer under nonqualified plans," *id.* at 11a, and "to encourage employers to create qualified plans for their employees." *Id.* at 13a. Concerned that a failure to extend the perceived "matching principle" to interest could weaken the incentive to establish qualified plans, the court refused to adhere to the "plain language interpretation" of its initial decision. *Id.* at 17a. Instead, the court reasoned that "despite the literal wording of the statute, Congress could not have intended to exclude interest payments, a substantial part of the deferred compensation package, from the rule prohibiting deductions until such time as the employee receives his benefits." *Id.* at 18a.

REASONS FOR GRANTING CERTIORARI

This unusual case presents two federal income tax issues that should be decided dispositively by this Court. The first issue, involving the current deductibility under section 163 of interest accrued under nonqualified deferred compensation plans, unquestionably is one of great significance under the Internal Revenue Code. Respondent concedes that this is so. In a petition for rehearing *en banc* authorized by the Solicitor General, respondent represented to the Ninth Circuit that this issue "is one of exceptional importance to the administration of the federal income tax laws" and that "[b]y any measure, this is a case of major fiscal importance." App. H at 101a, 102a. Respondent estimated the short-term revenue implications at seven billion dollars nationwide, and at two billion dollars in the Ninth Circuit alone. *Id.*

The ruling in this case is likely to "affect[] just about every nonqualified deferred compensation plan in the country." Tom Herman, *U.S. Appeals Court Overturns its Ruling in High-Stakes Tax Case*, Wall St. J., Dec. 6, 1994, at B12. There are thousands of such plans; their use is widespread throughout the corporate world. As respondent advised the Ninth Circuit, "more than 60% of the Fortune 500 utilize nonqualified deferred compensation plans . . . [and] [t]he use of such plans is not limited to major corporations." App. H at 101a. Hundreds if not thousands of corporate taxpayers, including many of the nation's largest companies, will be directly affected by the outcome of this case.

The publicity and attention given to the issue by both professional journals and the business press attest to its importance. Professional commentary on the decisions below has become something of a cottage industry. *See* J. Cummings, "Statutory Interpretation and *Albertson's*," Tax Notes, Jan. 23, 1995, p. 559 at 560 n.3 (citing 12 law review articles published within a period of less than eight months). Appealing to a more general readership, the Wall Street Journal has discussed the case on no

fewer than six occasions. *See* Wal' St. J. at B12 (Dec. 6, 1994); *Tax Report*, Wall St. J., June 29, 1994, at A1 ("the case will have a very broad impact"); *Tax Report*, Wall St. J. April 27, 1994, at A1; *Tax Report*, Wall St. J., April 6, 1994, at A1 ("an enormously important case"); *Tax Report*, Wall St. J. Feb. 9, 1994, at A1; *Tax Report*, Wall St. J., Jan. 19, 1994, at A1.

When it reversed itself, the Ninth Circuit explicitly recognized that the issue merits review by this Court: "The question is not an easy one . . . . We have struggled with it unsuccessfully at least once, and it may, indeed, ultimately turn out that the United States Supreme Court will tell us that it is this [second] opinion which is in error." App. A at 5a. This Court should accept the Ninth Circuit's invitation to review the case and proceed to fulfill that court's prophecy that its erroneous decision on rehearing will be overturned.

The second issue, involving the proper characterization under section 48 of HVAC systems used in retail food stores, also is important. There is a direct and acknowledged conflict between the Ninth and Eleventh Circuits on this issue. *See* App. B at 40a n.25.

This second issue affects virtually every owner of a modern food store, including not only operators of major supermarket chains like petitioner but also smaller establishments operating just one or a small number of stores. Although there inevitably is a factual element in determining whether an item constitutes "tangible personal property" within the meaning of section 48, the essential facts relating to HVAC systems are invariant for all modern food stores: (1) proper operation of open-front refrigerated food cases depends upon the maintenance of strict controls on ambient temperature and humidity, and thus upon the installation and use of an HVAC system; (2) HVAC systems also may incidentally provide for the comfort of customers and employees. *See* App. D at 75a-76a. In this context, the case of one supermarket

chain is not factually distinguishable from that of another. *Id.* at 79a. The Ninth Circuit evinced its understanding that the underlying issue is one of law rather than fact when it expressly "decline[d] to follow the Eleventh Circuit's holding" in *Piggly Wiggly Southern, Inc. v. Commissioner*, 803 F.2d 1572 (11th Cir. 1986), and chose instead to follow the contrary holding in *Publix Supermarkets, Inc. v. United States*, 26 Cl. Ct. 161 (1992). App. B at 40a n.25.

This conflict among the circuits should be resolved. Such a conflict is of particular concern in the supermarket industry, where nationwide chains operating on low margins compete with one another in many circuits. This case dramatizes that concern. Petitioner operates scores of food stores within the geographical area of the Eleventh Circuit, in direct competition with Piggly Wiggly. Yet because of the disagreement between the Ninth and Eleventh Circuits, petitioner suffers a distinct tax disadvantage. A circuit conflict that imposes different cost structures on direct competitors in the same local market should not be allowed to persist.

Although the investment tax credit was repealed by the Tax Reform Act of 1986, the underlying issue on which the Ninth and Eleventh Circuits disagree—the application of the "sole justification" test under Treas. Reg. § 1.48-1(e)(2) to supermarket HVAC systems—is one of continuing significance. The issue remains extremely important in the context of the deduction for depreciation. In defining "section 1245 property," Treas. Reg. § 1.1245-3(c)(2) expressly incorporates the definition of "structural components," including the "sole justification" test, contained in Treas. Reg. § 1.48-1(e)(2). The term "section 1245 property" is then used to determine whether property is real or personal for purposes of accelerated depreciation under section 168 of the 1986 Code. *See* Treas. Reg. § 1.168-3(c). Considerable tax liability and revenue must turn on that distinction: whereas non-

residential real property is subject to straight line depreciation over a lengthy 39-year recovery period, tangible personal property can qualify for 200 percent declining balance depreciation over a much shorter five-year recovery period. *See* section 168(b) and (c) of the 1986 Code.

In addition, the regulatory definition of "structural components" and the "sole justification" test continue to apply in at least three other situations under the 1986 Code. *See* Treas. Reg. § 1.168-3(c)(4) (depreciation recapture); Treas. Reg. § 1.897-1(b)(3)(iv) (disposition of certain foreign-owned property); section 47 of the Code (rehabilitation tax credit). The question whether supermarket HVAC systems meet the "sole justification" test, therefore, retains substantial vitality under current law. This Court should grant certiorari to resolve the circuit conflict on this issue created by the decision below.

Review of this case is further warranted because, as the following discussion demonstrates, both questions presented were incorrectly decided by the court of appeals.

I. *Section 404 does not bar the current deduction of interest accrued under a nonqualified deferred compensation plan.* Section 163(a) of the Code allows a deduction for "all interest paid or accrued within the taxable year on indebtedness." It has long been understood that "interest," within the meaning of this provision, retains its "usual, ordinary and everyday meaning," *Old Colony R.R. Co. v. Commissioner,* 284 U.S. 552, 561 (1931), and refers to an obligation to pay "for the use or forbearance of money." *Deputy v. du Pont,* 308 U.S. 488, 498 (1940). That definition fits this case like a glove. Under the terms of its deferred compensation agreements, petitioner became indebted to the participants for the amounts of their deferred compensation, and it undertook to accrue and ultimately to pay interest on that indebtedness at rates fairly representing the time value of money. App. B at 30. Petitioner's contractual obligation to pay interest on the funds thus borrowed from the

participants plainly "qualified as interest under the Code." *Id. See also* Note, "Employer Deductions Under Nonqualified Deferred Compensation Agreements: *Albertson's, Inc. v. Commissioner,*" 48 Tax Lawyer 493, 500-02 (1995); L. Shapiro & W. Pomierski, " 'Interest' on Deferred Compensation Arrangements May Be Deductible, for Now," J. Taxation 212, 213 (April 1994).

Even on rehearing, the Ninth Circuit did not disturb its prior determination that petitioner had accrued "interest . . . on indebtedness" within the meaning of section 163(a). The court conceded, moreover, that "under a literal reading of the statutory language, the deduction of interest is not affected by section 404." App. A at 16a. The court nonetheless held that section 404 must be construed as forbidding a current deduction for interest accrued under a nonqualified deferred compensation plan because, it believed, permitting a deduction would "undermine[] Congress' attempts to encourage employers to adopt qualified plans." *Id.* This "argument proves too much because it would support any limit on tax benefits related to nonqualified plans." J. Cummings, *supra*, Tax Notes at 572.

As written, section 404 favors qualified plans over nonqualified plans by allowing employers to take a current deduction for deferred compensation in connection with the former but not the latter. This alone is sufficient to provide a meaningful tax incentive for the adoption of qualified rather than nonqualified plans. *See* R. Dema & K. Frazier, "The Real Cost of Nonqualified Deferred Compensation Plans," J. Accountancy 86 (March 1995). The Ninth Circuit was gilding the lily when it went further and also barred employers with nonqualified plans from taking a current deduction for interest under section 163. The creation and limitation of tax incentives is, of course, a matter solely for Congress. Congressional enactment of a single, narrowly circumscribed tax incentive or disincentive plainly does not warrant the judicial

creation of still further incentives or disincentives that Congress itself did not see fit to legislate.

The decision below stands as a triumph of judicial policymaking over straightforward statutory construction. The Ninth Circuit "is in full rout before the intimidating force of 'tax logic,' i.e., what the code should say, whether it says so or not." J. Cummings, *supra*, Tax Notes at 559. That approach to statutory construction is seriously misguided and ultimately quite mischievous. "Going behind the plain language of a statute in search of a possibly contrary congressional intent is a 'step to be taken cautiously' even under the best of circumstances." *American Tobacco Co. v. Patterson*, 456 U.S. 63, 74-75 (1982). In this case, "there is simply no evidence that Congress intended to extend [section 404] to a deduction for interest." L. Shapiro & W. Pomierski, *supra*, J. Taxation at 214. Furthermore, "the legislative purpose perceived by the appeals court is nothing more than the court's own preference among competing policy considerations . . . ." E. Zelinsky, "*Albertson's*: Why Courts Shouldn't Override Clear Statutory Language," Tax Notes, March 13, 1995, p. 1691 at 1697.

Although the Ninth Circuit erred in both its path of reasoning and its final result, the court nonetheless was correct in acknowledging that the "plain language" of section 404 permits a current deduction for interest. App. A at 16a. Section 404 by its terms postpones the deduction only of "compensation." "The plain meaning of compensation here is payment for services." J. Cummings, *supra*, Tax Notes at 562. The underlying regulation confirms that section 404 is concerned solely with "compensation *for personal services actually rendered*." Treas. Reg. § 1.404(a)-1(b) (emphasis added). That also is the meaning of the same term elsewhere in the Code. *See, e.g.*, Treas. Reg. § 1.162-7(a) (defining compensation as "payments purely for services"). "It is a 'normal rule of statutory construction . . . that identical

words used in different parts of the same act are intended to have the same meaning.'" *Commissioner v. Keystone Consol. Indus., Inc.*, 113 S.Ct. 2006, 2011 (1993), quoting *Sorenson v. Secretary of Treasury*, 475 U.S. 851, 860 (1986). *See also, e.g., Commissioner v. Lester*, 366 U.S. 299, 304 (1961).

Nothing in either the text of section 404 or its legislative history suggests that Congress was using "compensation" to refer to interest on indebtedness as well as compensation for services. Such use would have been harshly discordant with congressional treatment of interest and compensation elsewhere in the Code:

> the code normally deals with interest and compensation explicitly and separately. Section 61 separately identifies interest, compensation, and other income items; sections 162, 163, and 267 do the same for deduction purposes. . . .
>
> Presumably, Congress meant compensation and not interest in section 404(a), because it knew that the code deals separately with compensation and interest.

J. Cummings, *supra*, Tax Notes at 564. When Congress has wished to refer both to compensation and interest in connection with deferred compensation arrangements, it has known how to do so. *See* section 457(a) of the 1986 Code (referring to "any amount of compensation deferred under the plan, *and any amount attributable to the amounts so deferred*") (emphasis added). Congress did not do so in section 404.

The text of section 404(a) as in effect during the taxable year at issue made explicit that only the deduction for compensation, and not that for interest, was subject to postponement: "if compensation is paid or accrued on account of any employee under a [nonqualified] plan deferring the receipt of such compensation, such . . . compensation shall not be [currently] deductible under section 162 (relating to trade or business expenses)

or section 212 (relating to expenses for the production of income)." There was no reference to, and no bar against, the current deduction of interest under section 163.

The explicit statutory reference to sections 162 and 212 was removed in 1986, and section 404(a) now provides that deferred compensation may not be currently deducted "under this chapter." The limited purpose of this amendment, which the Senate Report described as a mere "clarification," was "to prevent taxpayers from asserting that deferred compensation is attributable to capitalizable compensation expenses and, thereby, accelerate the timing of the deduction for such deferred compensation." S.Rep. No. 313, 99th Cong., 2d Sess. 1, 1013 (1986). In other words, Congress was just making clear that section 404 governs the deduction of deferred compensation that might otherwise be subject to capitalization and depreciation under section 167. *See Idaho Power Co. v. Commissioner*, 418 U.S. 1 (1974).

The 1986 amendment did not widen the focus of section 404(a); the statute remains narrowly addressed to the deductibility of "compensation." The amendment thus does not detract from the importance of the question presented or bear upon the correct analysis of that question under the statute. *See* App. B at 36a. Current Treasury regulations, issued in 1986 and amended as recently as 1992, confirm that section 404 analytically is no different now than in 1982 and that the statute remains today, as in 1982, concerned solely with the timing of the deduction for compensation normally deductible under section 162 or 212: "Section 404(a) and (d) require that . . . [deferred] compensation be paid or incurred for purposes of section 162 or 212 and satisfy the requirements for deductibility under either of those sections." Temp. Treas. Reg. § 1.404(a)-1T, Q&A-1, as amended by T.D. 8435, 1992-2 C.B. 324. In short, section 404 is not now, and was not in 1982, addressed to

or concerned with the current deductibility of interest under section 163.

In view of this background, it is not surprising that from 1977 until the time of the Tax Court's decision in this case one of the most widely distributed tax commentaries, the Standard Federal Tax Reporter published by Commerce Clearing House, advised that interest accrued under nonqualified deferred compensation plans is currently deductible under section 163. *See, e.g.*, [1977] 3 Stand. Fed. Tax Rep. (CCH) ¶ 2656A.25. As *amici curiae* Connecticut Mutual Life Insurance Company *et al.* demonstrated in their briefs below, this advice has been widely followed. The decision below on rehearing disappointed many taxpayers' settled expectations. Respondent's representation to the Ninth Circuit concerning the immediate revenue consequences of its initial decision, *see* App. H at 101a, appears to provide a fair measure of the extent of that disappointment. Taxpayers with nonqualified plans who had not previously claimed a current deduction for accrued interest could not begin to do so in the wake of the Ninth Circuit's initial decision without first securing respondent's permission to change their method of accounting—permission that respondent had discretion to deny and announced would be denied. *See* IRS Notice 94-38, 1994-1 C.B. 350; Rev. Proc. 92-20, 1992-1 C.B. 685, 703. The revenue estimates respondent furnished to the court thus presumably were based largely if not entirely on those taxpayers who, like petitioner, already were claiming the deduction.

The Ninth Circuit's result cannot be rationalized on policy grounds. In the first place, of course, "[i]f highly specific terminology in the tax code is to be overturned, that task belongs to Congress, not to the courts." Zelinsky, *supra*, Tax Notes at 1692. But beyond that, the court's choice of policy was highly dubious. The court was concerned to prevent petitioner from taking a deduction before its plan participants recognized income. But it is commonplace under the Code for one taxpayer to claim a deduc-

tion in one year and for another taxpayer to recognize the income relating to that deduction in a subsequent year. As one commentator has observed, "Every time an accrual-method taxpayer accrues an unpaid deduction attributable to an amount owed a cash-method taxpayer, an inconsistency arises. Every time. And, so what." S. Willis, "Leave *Albertson's* Alone," Tax Notes, June 13, 1994, p. 1481 at 1488. This "inconsistency" is merely a natural consequence of the right taxpayers have under the Code to choose between cash-basis and accrual-basis accounting. It is not a problem that cries out for judicial correction (nor is it, indeed, properly amenable to judicial solution).

The Ninth Circuit nonetheless became persuaded that section 404 should be applied to deal with this situation more broadly than its literal language would suggest, *i.e.*, as embodying a broad "matching principle" that requires all of an employer's deductions relating to nonqualified plans to be matched with an employee's recognition of income. *See* App. A at 11a-12a. The court thus lost sight of the Code's more general underlying matching principle: for any given taxpayer, "the Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of [that taxpayer's] net income for tax purposes." *Indopco, Inc. v. Commissioner*, 112 S.Ct. 1039, 1043 (1992). Section 404 constitutes a specific exception to this more general principle and as such should be narrowly construed, in accordance with its plain language, as applying only to compensation and not to interest. The Code's general matching principle directly supports the current deduction of interest accrued on borrowed funds that are used currently as working capital or otherwise to produce revenues in a taxpayer's business. It directly supports, in other words, petitioner's current deduction of interest under section 163.

By forcing petitioner to defer its interest deduction, the Ninth Circuit in fact "appl[ied] a solution . . . that Congress rejected." S. Willis, *supra*, Tax Notes at 1486. In section 467(g) of the 1986 Code, Congress delegated to the Secretary of Treasury authority (which the Secretary has not exercised) to promulgate regulations requiring, in connection with certain substantial deferred compensation arrangements, that even cash basis employees must recognize interest income in the year of accrual. Congress evidently understood that, absent such regulations, the Code itself does not require, explicitly or implicitly, that an employer's interest deduction be matched with the employee's recognition of income. Congress concluded, moreover, that in those circumstances where the Secretary determines that such matching is appropriate, it should be achieved by accelerating the employee's recognition of income, not by postponing the employer's deduction. The policy judgment reflected in section 467(g) thus is diametrically opposite the approach taken by the court below.

The policy the Ninth Circuit favored—requiring an accrual basis taxpayer to defer a deduction for accrued interest until it becomes includible in the gross income of a cash basis recipient—actually is reflected in section 267 of the Code. The reach of that provision, however, is narrowly and deliberately restricted to transactions between specifically identified parties, such as a corporation and a majority shareholder, or the fiduciary and beneficiary of a trust. Congress could have extended this rule to transactions between a corporation and its employees and thereby covered this case as well. But Congress did not do so. The Ninth Circuit should have been content to follow Congress' lead. The court obviously erred in departing from the actual text of the Code to devise and enforce its own idiosyncratic and nonstatutory tax policy.

The undeniable importance of the question presented under section 404, the Ninth Circuit's improper result-oriented reasoning process in addressing this question,

and the court's manifestly incorrect result, all lead ineluctably to the conclusion that "*Albertson's* is the rare corporate income tax case worthy of review by the Supreme Court even before a conflict is established among the circuits." E. Abahoonie, "Ninth Circuit's *Albertson's* Flip-Flop Outrages Practitioner," Tax Notes, Feb. 6, 1995, p. 898.

II. *Supermarket HVAC systems constitute "tangible personal property" within the meaning of section 48.* The investment tax credit provided by section 38 of the Code extended to investments in so-called "section 38 property," which section 48(a)(1)(a) defined as including "tangible personal property." The latter term is defined by Treas. Reg. § 1.48-1(c) to exclude "structural components of . . . buildings." In turn, Treas. Reg. § 1.48-1(e)(2) provides that "the term 'structural components' does not include machinery the sole justification for the installation of which is the fact that such machinery is required to meet the temperature and humidity requirements which are essential to the operation of other machinery." Thus HVAC systems qualified for the investment tax credit if, within the meaning of Treas. Reg. § 1.48-1(e)(2), the "sole justification" for their installation was to meet the temperature and humidity requirements of open-front refrigerated food cases.

Respondent concedes that "petitioner's retail food stores require HVAC systems to keep ambient store temperature within case manufacturers' specifications and prevent spoilage." App. D at 79a. This now is a standard characteristic of food stores generally: "Unlike other commercial buildings, supermarkets do not base air conditioning on comfort considerations. Rather, air conditioning works together with the refrigerators in keeping perishable foods at proper temperature." Tr. 220-21 ("Tr." refers to the trial transcript). The Department of Energy recognized this industry-wide phenomenon when it proposed regulations exempting food stores from heating and cooling standards applicable to other business

establishments, noting that "temperature and humidity levels other than those mandated in the regulations are required . . . for the proper refrigeration of perishable items on open shelf units." 44 Fed. Reg. 31927, 31928 (1979). *See also* App. D at 75a.

The Ninth Circuit nevertheless held that meeting the requirements of refrigerated food cases cannot be considered the "sole justification" for installing HVAC systems in food stores, because such systems also provide "ventilation and customer comfort." App. B at 38a. Although the court couched its reasoning in terms of "clear error," *id.* at 39a, its holding was not grounded in either the particular facts of this case or any evidence pertaining to the industry generally. Both petitioner and respondent presented evidence that suitable ventilation is an integral part of any system designed to maintain the temperature and humidity conditions necessary for the proper operation of in-store food refrigeration equipment. See Tr. 435; Cmr. Exs. EA and EF ("Cmr. Ex." refers to respondent's trial exhibits). That is, indeed, little more than common sense. As to customer comfort, moreover, there is abundant evidence that, in fact, customers frequently criticize both petitioner's supermarkets and those of its competitors for being uncomfortably cold. *See, e.g.*, App. D at 74a; *Piggly Wiggly*, 803 F.2d at 1576 n.16.

At bottom, the Ninth Circuit's decision turned on its erroneous construction of the regulatory term "sole justification" to mean "exclusive justification." Although Treas. Reg. § 1.48-1(e)(2) does not comprehensively define "sole justification," it does make clear that the phrase is not to be construed literally as disallowing a secondary or incidental purpose for the installation of HVAC systems:

> Machinery may meet the "sole justification" test . . . even though it incidentally provides for the comfort of employees, or serves, to an insubstantial degree, areas where such temperature or humidity requirements are not essential. For example, an air condi-

> tioning and humidification system installed in a textile plant in order to maintain the temperature or humidity within a narrow optimum range which is critical when processing particular types of yarn or cloth is not included within the term "structural components."

Consequently, "sole justification" cannot be equated with "*exclusive* justification." *Piggly Wiggly*, 803 F.2d at 1575 (emphasis in original). Instead, the regulation calls for a "balancing of the 'sole justification' versus 'incidental benefits.'" *Id.*

The Ninth Circuit explained its refusal to undertake such a balancing on the ground that the regulatory "comfort exception applies only to *employees*." App. B at 39a (emphasis in original). That reading of the regulation defies common sense. In referring to the comfort of employees, the regulation merely furnishes a specific illustration of the application of a more general rule, *i.e.*, HVAC systems that are essential to the operation of other machinery do not become "structural components" merely because they afford the incidental benefit of a more comfortable environment. A distinction between the comfort of employees and that of customers in this context has no rational bearing on whether an HVAC system should be considered a "structural component," and the regulation in fact does not draw any such distinction.

Rationally construed, Treas. Reg. § 1.48-1(e)(2) is not concerned with the identity of those who may be incidentally benefitted by the installation of an HVAC system, whether they are customers, suppliers, employees, or other business invitees. As the Eleventh Circuit correctly understood, the "sole justification" test is satisfied whenever HVAC systems are installed "to meet equipment specifications [even though] *customer and worker* comfort was an incidental benefit." *Piggly Wiggly*, 803 F.2d at 1575 (emphasis added). In short, even if supermarket customers are made more comfortable as a result of the installation of new HVAC systems—and there is evidence

that they frequently are not, *see, e.g.*, App. D at 74a—such systems nonetheless satisfy the regulatory "sole justification" test.

The conflict between the Ninth and Eleventh Circuits leaves the law unsettled on an issue of considerable continuing practical significance and will encourage further litigation. This Court can nip that growth of litigation in the bud by resolving the conflict now. Indeed, the Court has the opportunity to, and should, "kill two birds with one stone" by accepting and deciding both of the important questions of federal income tax law presented in this case.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX A

UNITED STATES COURT OF APPEALS
NINTH CIRCUIT

Nos. 91-70380, 91-70381

ALBERTSON'S, INC.,
Petitioner-Appellant-Cross-Appellee,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee-Cross-Appellant.

Appeal from the United States Tax Court

Reargued and Submitted June 29, 1994

Decided Dec. 5, 1994

Before: CANBY and REINHARDT, Circuit Judges, and TASHIMA, District Judge.*

REINHARDT, Circuit Judge:

On December 30, 1993, we filed an opinion concerning various disputes between Albertson's and the Internal

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* The Honorable A. Wallace Tashima, United States District Judge for the Central District of California, sitting by designation.

Revenue Service. 38 F.3d 1046 (9th Cir.1993). We granted the government's petition for rehearing as to Part II.B of the opinion, which concerned the appropriate tax treatment of deferred compensation agreements. Today we vacate Part II.B of the original opinion and affirm the Tax Court's decision.

I. *BACKGROUND*

Deferred compensation agreements ("DCAs") are agreements in which certain employees and independent contractors ("DCA participants") agree to wait a specified period of time ("deferred period") before receiving the annual bonuses, salaries, or director's fees that they would otherwise receive on a current basis. During the deferral period, the employer uses the basic amounts of deferred compensation ("basic amounts"), which accumulate on an annnual basis, as a source of working capital. At the end of the deferral period, the employer pays the participating individuals the basic amounts *and* an additional amount for the time value of the deferred payments that have accumulated on the basic amounts ("additional amount"). The time-value-of-money sums are also computed on a yearly basis. The total of these basic amounts and the amounts attributable to compensation for the delay in payment of those amounts constitutes the whole of the deferred compensation ("deferred compensation"). The time-value-of-money component may be measured by interest rate indices, equity fund indices, or cost of living increases, or it may simply be included within a lump-sum payment.

Prior to 1982, Albertson's entered into DCAs with eight of its top executives and one outside director. The parties agreed that their deferred compensation would include the annual basic amounts plus additional amounts calculated annually in accordance with an established formula. *Albertson's, Inc. v. Commissioner,* 38 F.3d 1046,

1051 (9th Cir.1993).[1] The DCA participants would be eligible to receive the deferred compensation (the total sum) upon their retirement or termination of employment with Albertson's. The DCA participants also had the option of further deferring payment for up to fifteen years thereafter. During that extra period, the additional amounts would continue to accrue on an annual basis. *Id.* at 1052.

In 1982, Albertson's requested permission from the IRS to deduct the additional amounts (but not the basic amounts) during the year in which they accrued instead of waiting until the end of the deferral period. *Id.* In 1983, the IRS granted Albertson's request. Accordingly, Albertson's claimed deductions of $667,142 for the additional amounts that had already accrued, even though it had not yet paid the DCA participants any sums under the deferred compensation agreements. *Id.* In 1987, the IRS changed its policy, however, and sought a deficiency for the additional amounts, contending that all amounts provided for in the deferred compensation agreements were deductible only when received by Albertson's

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[1] The terms of the eight executives' agreements were as follows:

> 3.1 The COMPANY agrees to defer payment of certain compensation earned by EMPLOYEE during each fiscal year, such deferred compensation to be paid to EMPLOYEE after EMPLOYEE'S employment is terminated. The compensation to be deferred shall be as set forth . . . below.
>
> . . . . .
>
> 3.2 The COMPANY agrees to pay to EMPLOYEE a further sum of money equal to the amount of interest accrued which shall be calculated by applying the rate of interest to the total accumulated amount of deferred compensation including accrued interest compounded monthly. The rate to be used will be the weighted average of the COMPANY's long term borrowing rate for that current fiscal year.
>
> . . . . .

The outside director's additional amount was calculated at a rate equivalent to the rates for new certificates of deposit over $1,000,000 as published in the Wall Street Journal.

employees. Albertson's filed a petition with the Tax Court, claiming that the additional amounts constituted "interest" and thus could be deducted as they accrued. *Id.*

In a sharply divided opinion,[2] the Tax Court rejected Albertson's position. *Albertson's, Inc. v. Commissioner*, 95 T.C. 415, 1990 WL 149185 (1990). The court found that the additional amounts represented compensation, not interest, and were therefore not deductible until the end of the deferral period under I.R.C. § 404(a)(5) & (d).

We reversed the decision of the Tax Court. *Albertson's, Inc. v. Commissioner*, 38 F.3d 1046 (9th Cir. 1993). We held that the additional amounts constituted interest within the definition of I.R.C. § 163(a) and that interest payments were not governed by the timing restrictions of section 404. The government petitioned for rehearing due to the significant fiscal impact of the panel's opinion which it estimates will cause a $7 billion loss in tax revenues.

II. *REHEARING*

We agree to rehear this issue after lengthy consideration and reflection. In our original opinion, we stated that the plain language of the statute strongly supported Albertson's interpretation and, accordingly, we adopted it. Neverthless, we expressed sympathy for the Commissioner's argument that Congress intended the timing restrictions of I.R.C. § 404 to apply to *all* payments made

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[2] The nine-member majority held that the additional amount was not currently deductible because it was not interest. The four-member concurrence argued that the additional amount was interest, but that section 404's timing restrictions applied to both compensation and interest. The five-member dissent argued that the additional amount was interest and that section 404's timing restrictions applied *only* to compensation. One judge did not participate, and one judge voted in favor of the majority *and* the concurrence. Thus, twelve judges agreed that the additional amounts were not deductible interest under section 404.

under a deferred compensation plan and recognized that our plain language interpretation seemed to undercut Congress' purpose.

We have now changed our minds about the result we reached in our original opinion and conclude that our initial decision was incorrect. The question is not an easy one, however. We have struggled with it unsuccessfully at least once, and it may, indeed, ultimately turn out that the United States Supreme Court will tell us that it is this opinion which is in error. This is simply one of those cases—and there are more of them than judges generally like to admit—in which the answer is far from clear and in which there are conflicting rules and principles that we are forced to try to apply simultaneously. Such accommodation sometimes proves to be impossible. In some cases, as here, convincing arguments can be made for both possible results, and the court's decision will depend on which of the two competing legal principles it chooses to give greater weight to in the particular circumstance. Law, even statutory construction, is not a science. It is merely an effort by human beings, albeit judges, to do their best with imperfect tools to arrive at a correct result.

There is a question whether, having once decided a case, we should change our decision when we are not entirely certain that the result we reached is wrong. One response is that, if the issue could be resolved with that degree of certainty, it is unlikely that we would have decided the case incorrectly the first time. Moreover, if certainty were the standard, we would probably never reverse ourselves. There is actually no clear set of rules that tells us when a case warrants our changing our decision on rehearing. We start with the premise that doing so is not generally desirable, and that it runs contrary to the sense of stability and finality that the law seeks to foster. We also know that it is often better to have a definitive answer, whatever it is, than to have continuing reexaminations or self-questioning.

On the other hand, we judges do not just bury our mistakes. We display them publicly in the Federal Reporters and, while we may then as individuals move on to more decisionmaking, the opinions we have published continue to haunt indefinitely not just the parties, but often numerous other persons whose affairs and fortunes will be governed by them.[3] Because all of us make hundreds of difficult decisions a year involving complex legal questions, we know that we will make a certain number of errors. All that we can do is to try our best to hold them to a minimum. At the same time, if a rehearing is requested and we have a strong sense that we may have erred in the particular case, we should not hesitate to undertake a reexamination of the issue. This is particularly so when significant individual rights or interests are at stake or when a number of parties may be seriously affected by a decision that may be erroneous. Given all of this, our conclusion is that, while we should not ordinarily abandon the decisions we have just reached following full deliberation, we must be willing to take that unusual step—at least in cases of some significance—when ultimately we are fairly persuaded that our decision is in error. This is such a case.

In its petition for rehearing, the government, far more forcefully and clearly than it did originally, has articulated the purpose of the timing restrictions outlined in I.R.C. § 404: to encourage employers to invest in qualified compensation plans by requiring inclusions and deductions of income and expense to be "matched" for nonqualified plans. *See infra* p. 543. The matching principle, widely recognized to be the key to I.R.C. § 404, provides significant tax incentives for employers to invest in *qualified* deferred compensation plans, which are nondiscriminatory and ensure that employees receive the compensation promised to them. *See* 2 Boris I. Bittker

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[3] Unless, as is possible in some cases, including this one, Congress legislates otherwise.

& Lawrence Lokken, *Federal Taxation of Income, Estates & Gifts* ¶ 60.1 (2d ed. 1990) (noting that the "matching principle" is "the most consistent feature of the rules for nonqualified plans."). As the Commissioner forcefully argues, our original interpretation of I.R.C. § 404 undercut the essential purpose of that provision by violating the matching principle and creating a taxation scheme that favors the type of plan that Congress intended to discourage. *See infra* pp. 542-45. For this reason, we granted the Commissioner's petition for rehearing. We now withdraw the portion of our earlier opinion that dealt with deferred compensation agreements, published at 38 F.3d at 1051-1056, and affirm the Tax Court's decision, although not for the reasons upon which the Tax Court majority relied.

III. *ANALYSIS*

Albertson's again urges this court (1) to characterize the additional amounts as interest as defined by I.R.C. § 163(a),[4] and (2) to find that such "interest" payments are deductible under I.R.C. § 404.[5] However, we have

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[4] The relevant language of I.R.C. § 163 is as follows:

> (a) GENERAL RULE.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

[5] The relevant provisions, at the time Albertson's filed its 1983 tax return, were as follows:

> Sec. 404. Deductions for . . . compensation under a deferred-payment plan.
>
> (a) General rule— . . . [I]f compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such . . . compensation shall not be deductible under section 162 (relating to trade or business expenses) or section 212 (relating to expenses for the production of income); but if they satisfy the conditions of either such sections, they shall be deductible subject, however, to the following limitations as to the amounts deductible in any year . . .
>
> (5) If the plan is not one included in paragraph (1), (2), or (3) [relating to pension trusts, annuities, and stock bonus

now concluded that, notwithstanding the statutory language on which Albertson's relies, to hold the additional amounts to be deductible would contravene the clear purpose of the taxation scheme Congress created to govern deferred compensation plans. As the Supreme Court noted in *Bob Jones University v. United States*, 461 U.S. 574, 103 S.Ct. 2017, 76 L.Ed.2d 157 (1983), a term in the Code "*must* be analyzed and construed within the framework of the Internal Revenue Code and against the background of the congressional purposes." *Id.* at 586, 103 S.Ct. at 2026 (emphasis added).

A. *A Comparison of Qualified and Nonqualified Plans*

An examination of the differences between qualified and nonqualified plans is essential to an understanding of the purpose of the congressional scheme governing deferred compensation agreements. Congress has imposed few restrictions upon nonqualified deferred compensation plans. An employer may limit participation in a nonqualified plan to highly paid executives, and it need not guarantee equal benefits for all participants. In addition, the employer is not required to set aside any funds or provide any guarantees (beyond the initial contractual promise) that its employees will receive the compensation. Thus, promised benefits for unfunded, nonqualified plans are subject to the claims of the employer's general creditors.

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and profit-sharing trusts], in the taxable year in which an amount attributable to the contribution is includible in the gross income of employees participating in the plan. . . .

(d) Deductibility of payments of deferred compensation, etc., to independent contractors.—If a plan would be described [as above] . . . [the] compensation—

(1) shall not be deductible by the payor thereof under section 162 or 212, but

(2) shall . . . be deductible under this subsection for the taxable year in which an amount attributable to the . . . compensation is includible in the gross income of the persons participating in the plan.

Under a qualified plan, in contrast, an employer may not discriminate in favor of officers, shareholders, or highly compensated employees. I.R.C. § 401(a)(4) & (a)(5). In addition, a qualified plan must satisfy minimum participation and coverage standards concerning eligibility and actual rates of participation. I.R.C. §§ 401(a)(2) & (a)(26), 410. The amounts which an employer may contribute to qualified plans and the benefits which qualified plans may provide are also restricted. I.R.C. §§ 401(a)(17), 415.

A qualified plan also provides significant guarantees that employees will receive the compensation promised to them. It generally must be funded through a trust. I.R.C. § 401(a). Neither the corpus nor the income of the trust may be diverted for any purpose; they can only be used for the exclusive benefit of the participants. I.R.C. § 401(a)(2). Under certain qualified plans, the employer's contributions must meet strict funding requirements, and minimum standards govern the vesting of participants' benefits. I.R.C. §§ 401(a)(1) & (a)(7), 411, 412; *see also* 29 U.S.C. § 1082.

It is clear that few employers would adopt a qualified deferred compensation plan, with all of its burdensome requirements, if the taxation scheme favored nonqualified plans or treated nonqualified and qualified plans similarly. Although qualified plans provide significant benefits to employees, they allow employers little flexibility in structuring a plan, require them to provide extensive coverage, prevent them from discriminating in favor of highly compensated employees, and involve a significant initial outlay of funds. Thus, the extensive regulations Congress has imposed upon qualified plans would serve little purpose unless employers had an incentive to adopt such plans. As we discuss in the next part, section 404 provides the incentive necessary to encourage employers to adopt qualified plans by providing significantly more favorable tax treatment of qualified plans than of nonqualified ones.

The most significant difference between the two types of plans, for purposes of tax deductibility, is that under a qualified plan the employer must turn over annually to a third party the basic amounts that are deferred and may not use those amounts for the employer's own benefit. Thus, the employer, in effect, is required to make the deferred payments at the time the employee is earning the compensation. It is only the employee's right to receive the funds that is delayed. In contrast, an employer with a nonqualified plan is not required to turn any funds over to anyone until the end of the deferred compensation period. Such an employer may use those funds for its own purposes for a period of many years. In a nonqualified plan, it is not only the employee's right to receive the funds that is deferred; the employer's obligation to part with the funds is deferred as well. If one could simply retain the funds and receive tax benefits similar to those one would receive if those amounts were paid out, there would clearly be little incentive to establish a qualified plan.

B. *The Purpose of Section 404*

Congress enacted section 23(p), the forerunner to section 404, in 1942. Prior to 1942, corporations were allowed to deduct DCA-related expenses as they accrued each year, even though employees did not recognize any income until a subsequent taxable year. In 1942, Congress eliminated this favorable treatment for deductions relating to "nonqualified" deferred compensation agreements, such as the DCAs at issue in this case.[6] In so

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[6] The relevant provision is as follows:

§ 23 Deductions from gross income

. . . .

(p) Contributions of an employer to an employees' trust or annuity plan and compensation under a deferred-payment plan.

[Continued]

doing, Congress forced employers who chose to retain their funds for their own use to wait until the *end* of the deferral period, when these amounts were includible in plan participants' taxable income, before they could take deductions for deferred compensation payments. However, employers who maintained a "qualified" plan that met the rigorous requirements of the Internal Revenue Code (and now ERISA), including turning over the sums involved to a trust fund (or purchasing an annuity), were allowed to continue to take the annual deductions even though their employees would not receive the deferred compensation until a later year. *See, e.g.*, I.R.C. §§ 404(a) & (d); 29 U.S.C. § 1082 (1988).

1. *The Matching Principle*

Congress provided a single explanation for the timing restrictions of section 404: to ensure matching of income inclusion and deduction between employee and employer under nonqualified plans. As both the House and Senate Reports note, "[i]f an employer on the accrual basis defers paying any compensation to the employee until a later year or years . . . he will not be allowed a deduction until the year in which the compensation is paid." H.R.Rep. No. 2333, 77th Cong., 2d Sess. (1942), 1942-2 Cum.Bull. 372, 452; S.Rep. No. 1631, 77th Cong., 2d Sess. (1942), 1942-2 Cum.Bull. 504, 609.

Commentators have widely agreed that this "matching principle" is the key to section 404. As Boris Bittker and Lawrence Lokken have observed, "[t]he most consistent

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[6] [Continued]

(1) General Rule.

If . . . compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such . . . compensation shall not be deductible under subsection (a) [business expenses] but shall be deductible, if deductible under subsection (1) without regard to this subsection, under this subsection.

I.R.C. § 23 (1942).

feature for the rules for nonqualified plans is that the employer is ordinarily allowed no deduction for contribution, payments or benefits until they are taxed to the employee." 2 Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates & Gifts* ¶ 60.1 (2d ed. 1990). Similarly, Daniel Halperin has noted that, in the case of deferred payment of compensation under nonqualified plans, Congress has imposed "a matching requirement, which denies an employer's deduction until the deferred amount is included in the employee's income." Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money"*, 95 Yale L.J. 506, 520 (1986) (discussing section 404). David Davenport also cites section 404 as the primary proof that "[c]urrent law follows a matching principle and defers the employer's deduction until the year of payment." David S. Davenport, *Education & Human Capital: Pursuing an Ideal Income Tax and a Sensible Tax Policy*, 42 Case W.Res.L.Rev. 793, 865 (1992); *see also Merten's Law of Federal Income Taxation*, Comm. § 404 (1990 & 1994 Supp.); Joseph L. Cummings, Jr., *The Silent Policies of Conservation and Cloning of Tax Basis and Their Corporate Application*, 48 Tax L.Rev. 113, 162 n. 245 (1992) (noting that the matching principle governs section 404); Noel B. Cunningham, *A Theoretical Analysis of the Tax Treatment of Future Costs*, 40 Tax L.Rev. 577, 610 (1985) (same) Mark P. Gergen, *Reforming Subchapter K: Compensating Service Partnerships*, 48 Tax L.Rev. 69, 97 n. 91 (1992) (same).

2. *The Significance of the Matching Principle*

The significance of section 404's matching principle becomes evident when one compares the treatment of qualified and nonqualified plans under that section. Because section 404 requires employer deductions for contributions to nonqualified plans to be "matched," an employer cannot take tax deductions for payments to its employees until the DCA participants include those pay-

ments in their taxable income—that is, until the employees actually receive the compensation promised to them.

Qualified plans, in contrast, are *not* governed by the matching principle and consequently generate concurrent tax benefits to employers. Although employees are not taxed upon the benefits they receive from the plan until they actually receive them, an employer's contributions to a qualified plan are deductible when paid to the trust. I.R.C. §§ 402(a)(1) & 404(a). Thus, the employer may take an *immediate, unmatched* deduction for any contribution it makes to a qualified plan.[7]

By exempting contributions to qualified plans from the matching principle, Congress compensates employers for meeting the burdensome requirements associated with qualified plans by granting them favorable tax treatment. The current taxation scheme thus creates financial incentives for employers to contribute to qualified plans while providing no comparable benefits for employers who adopt plans that are unfunded or that discriminate in favor of highly compensated employees.

C. *The Effects of Albertson's Proposal*

Albertson's maintains that section 404 only requires that the basic amounts of compensation be matched; it argues that all additional amounts paid to compensate an employee for the time value of money represent "interest" payments for which an employer may take an immediate deduction. In light of the clear purpose underlying section 404—to encourage employers to create qualified plans for their employees—we decline to ascribe such an intention to Congress.

First, Albertson's proposal appears to undermine the effectiveness of the timing restrictions by reducing the

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[7] In addition, the earnings of a trust established by a qualified plan are not taxable to the trust. I.R.C. §§ 401(a) & 501(a).

significance of the incentive structure created by section 404. In order to adopt Albertson's proposal and allow employers to take current deductions for additional "interest" payments, we would be required to conclude that Congress created a system in which employers could deduct a substantial portion of the nonqualified deferred compensation package long before its employees had received any of those funds. For example, when the additional amounts are calculated for a compensation package deferred over a fifteen-year period using an interest rate similar to that used by Albertson's, an employer can classify more than seventy percent of the deferred compensation package as "interest payments." [8] If the additional amounts were calculated at an eight percent interest rate, compounded annually, almost fifty percent of the compensation package could be characterized as "interest" under Albertson's approach. Even under a deferred compensation package with an interest rate one-third as high as Albertson's, one third of the amount paid to the employee at the end of a fifteen-year period would consist of "interest." Moreover, we note that, under Albertson's deferred compensation agreement, participants have the option of deferring payment of the total sum available to them upon retirement for an additional period of up to fifteen years. *All* payments during that additional period would also constitute "interest," and the deductible portion of the final compensation package would thus increase exponentially.

Albertson's has been unable to explain why Congress, in designing a taxation scheme to encourage the creation of qualified plans, would require an employer that maintains a nonqualified plan to defer taking a deduction on the basic amounts of a promised compensation package but nevertheless allow that employer to take current deductions on amounts that constitute a substantial portion

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[8] According to the record, it appears that Albertson's employees were compensated at a 14.8% interest rate, compounded monthly.

of the compensation package, merely because that portion is classified as "interest." Given that the interest payments will often constitute the bulk of the total compensation package that an employee under a nonqualified plan ultimately receives, it would make little sense to impose a matching requirement upon "basic" payments but not upon "interest" payments. Albertson's interpretation of section 404 would seriously undermine the incentive structure designed by Congress to encourage employers to establish qualified plans.

An additional reason to reject Albertson's statutory interpretation of section 404 is that, in certain cases, Albertson's approach might actually create an incentive for employers to establish *nonqualified* plans. Whereas an employer who maintains a qualified plan may only take a current deduction for the basic amounts of promised compensation, an amount it actually has paid out, under Albertson's approach an employer that maintains a nonqualified plan could take current deductions for "interest" payments that substantially exceed the basic amounts even though it has paid out none of these funds. Moreover, the employer could take advantage of these tax benefits without being constrained by the burdensome requirements associated with qualified plans. For this reason, characterizing the additional amounts as deductible interest, as Albertson's suggest, would encourage employers to maintain nonqualified plans and thus directly contradict the statutory purpose underlying I.R.C. § 404.[9]

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[9] We also note the government's argument concerning the possible consequences of a finding in favor of Albertson's. According to the Commissioner, under a long-standing administrative practice, employees are currently not taxed upon the benefits they receive from deferred compensation plans until they actually receive them precisely because employers have not taken deductions for those amounts. Because section 404 only exempts payments under qualified plans from the matching principle, were we to uphold Albertson's approach, the Commissioner suggests that we would be required to conclude that employer deductions for interest ac-

Thus, Albertson's proposal runs counter to the congressional scheme. It undermines Congress' attempts to encourage employers to adopt qualified plans and, in some cases, directly contradicts the purpose of section 404 by creating an incentive to create nonqualified plans.

D. *Albertson's Response*

Albertson's has not been able to refute the argument that its interpretation of section 404 undercuts the provision's central purpose. Equally important, it offers us no reason why Congress would have wanted to treat the "interest" part of the deferred compensation package differently from the basic amounts for tax purposes.

Instead, Albertson's rests its argument upon its contention that, because the plain language of § 404 only refers to "compensation" rather than "interest," the employers have a statutory right to deduct the additional amounts as interest under § 163. In this connection. Albertson's points out that section 404 prohibits deduction under sections 162 and 212 but not under section 163, and it is the latter section that governs the deduction of interest. Albertson's argument as to the plain language of the statute is a strong one. We certainly agree that the additional payments resemble "interest" and that, under a literal reading of the statutory language, the deduction of interest is not affected by section 404. However, holding such payments to be deductible "interest" under section 404 would lead to an anomalous result: a taxation scheme designed to make nonqualified plans less attractive would in many cases provide incentives for

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cruing under nonqualified plans must be "matched" by the inclusion of those amounts in employees' current taxable income. As is clear from the foregoing discussion, such an unrealized addition to the employees' income for tax purposes would indeed be substantial and, as far as the employees are concerned, harshly inequitable. We express no opinion about the merits of the government's argument.

adopting such plans, and a provision intended to apply the matching principle to nonqualified deferred compensation agreements would exempt substantial portions of DCA payments from its application.

In the end we are forced, therefore, to reject Albertson's approach. We may not adopt a plain language interpretation of a statutory provision that directly undercuts the clear purpose of the statute. In *Brooks v. Donovan*, 699 F.2d 1010 (9th Cir.1983), we refused to adopt a plain language interpretation of a statute governing pension funds. We reasoned that the "court must look beyond the express language of a statute where a literal interpretation 'would thwart the purpose of the overall statutory scheme or lead to an absurd or futile result.' " *Brooks*, 699 F.2d at 1011 (quoting *International Tel. & Tel. Corp. v. General Tel. & Elec. Corp.*, 518 F.2d 913, 917-918 (9th Cir.1975)). In reaching our conclusion, we followed the Supreme Court's approach in *United States v. American Trucking Ass'ns.*, 310 U.S. 534, 60 S.Ct. 1059, 84 L.Ed. 1345 (1940). There the Court noted that "[w]hen [a given] meaning has led to absurd results . . . this Court has looked beyond the words to the purpose of the act. Frequently, however, *even when the plain meaning did not produce absurd results but merely an unreasonable one 'plainly at variance with the policy of the legislation as a whole,' this Court has followed that purpose, rather than the literal words.*" *American Trucking Ass'ns.*, 310 U.S. at 543 (emphasis added; citations omitted).

The Supreme Court's decision in *Bob Jones University v. United States*, 461 U.S. 574, 103 S.Ct. 2017, 76 L.Ed.2d 157 (1983), provides especially useful guidance in this regard. In *Bob Jones University*, the Supreme Court addressed the question of whether I.R.C. § 501 (c)(3)—which provides that "corporations . . . organized and operated exclusively for religious, charitable . . . or educational purposes" are entitled to tax exemption—

included educational institutions with racially discriminatory policies. Even though Congress had explicitly outlined eight categories of exempt organizations in section 501(c)(3) without making any mention of additional requirements beyond those outlined in the statute, the Supreme Court interpreted the statute to include an additional requirement: the organization in question must serve a valid charitable purpose. *Bob Jones University*, 461 U.S. at 592 n. 19, 103 S.Ct. at 2029 n. 19. Thus, the Court was willing to read additional language into the text of the statute because an alternative interpretation would undermine the fundamental purpose of the legislation. As the Court itself noted, "[i]t is a well-established canon of statutory construction that a court should go beyond the literal language of a statute if reliance on that language would defeat the plain purpose of the statute." *Id.* at 586, 103 S.Ct. at 2025.

In rejecting Albertson's appeal, we take heed of the Supreme Court's instructions concerning the proper interpretation of the Internal Revenue Code when the plain language of the provision leads to an unreasonable result and directly contradicts its underlying purpose: the provision "*must* be analyzed and construed within the framework of the Internal Revenue Code and against the background of the congressional purposes." *Id.* (emphasis added). For the reasons we have expressed, we conclude that, despite the literal wording of the statute, Congress could not have intended to exclude interest payments, a substantial part of the deferred compensation package, from the rule prohibiting deductions until such time as the employee receives the benefits. Indeed, the matching principle would not be much of a principle if so substantial a part of the deferred compensation package were excluded from its operation.

IV. *CONCLUSION*

In sum, we decline to adopt Albertson's interpretation of I.R.C. § 404. Whether or not the additional amounts constitute interest, allowing Albertson's to deduct them prior to their receipt by their employees would contravene the clear purpose of the taxation scheme governing deferred compensation agreements. Accordingly, we vacate the portion of our original opinion dealing with deferred compensation agreements and affirm the Tax Court's holding that Albertson's may not currently deduct the additional amounts.

AFFIRMED.

APPENDIX B

THE UNITED STATES COURT OF APPEALS
NINTH CIRCUIT

Nos. 91-70380, 91-70381

ALBERTSON'S, INC.,
Petitioner-Appellant-
Cross-Appellee,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee-
Cross-Appellant.

Appeal from the United States Tax Court

Argued and Submitted March 4, 1993

Submission Vacated March 11, 1993

Resubmitted April 21, 1993

Decided Dec. 30, 1993

Before: CANBY, and REINHARDT, Circuit Judges, and TASHIMA, District Judge.*

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* The Honorable A. Wallace Tashima, United States District Judge for the Central District of California, sitting by designation.

OPINION

REINHARDT, Circuit Judge:

I. OVERVIEW

Petitioner Albertson's, Inc. ("Albertson's")[1] appeals two decisions of the United States Tax Court. In the first decision, the Tax Court held that Albertson's was not entitled to claim work incentive tax credits ("WIN credits") retroactively for its past hiring of certain welfare recipients. *See Albertson's, Inc. v. Commissioner*, 59 T.C.M. (CCH) 186, 1990 WL 29271 (1990). In the second decision, the Tax Court held that Albertson's was not entitled to claim current deductions for interest-like obligations that had accrued under deferred compensation agreements ("DCAs") made with certain of its top executives and directors. *See Albertson's, Inc. v. Commissioner*, 95 T.C. 415, 1990 WL 149185 (1990).

Respondent Commissioner of Internal Revenue ("Commissioner") cross-appeals a third decision of the United States Tax Court. In the third decision, the Tax Court held that Albertson's was entitled to claim investment tax credits for its heating, ventilating, and air-conditioning ("HVAC") systems. *See Albertson's, Inc. v. Commissioner*, 56 T.C.M. (CCH) 928, 1988 WL 137121 (1988).

We affirm the Tax Court with respect to its judgment on the first issue (WIN credits). We reverse the Tax Court with respect to its judgment on the second issue (DCAs). We also reverse the Tax Court with respect to its judgment on the third issue (HVAC credits). We discuss each issue separately below.

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[1] Petitioner, a Delaware corporation, has its principal place of business in Boise, Idaho. Petitioner operates over 400 retail food and drug stores in the western, southern, and southeastern United States. Petitioner is an accrual basis taxpayer.

II. DISCUSSION

A. Work Incentive Credits

1. Background. In 1971, Congress established work incentive ("WIN") tax credits to provide employers with an incentive to hire employees who might otherwise receive public assistance. Participating employers were required to submit certifications from state agencies showing that their employees were either receiving welfare assistance or participating in a work-incentive program at the time they were hired.[2] In return, the employer would receive a tax credit equal to a portion of the employee's first- and second-year wages.

Prior to January 29, 1982, Albertson's had hired numerous employees who qualified for the WIN credits. Some of these employees remained unidentified, however, and Albertson's was unable to claim any credits for

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[2] Prior to 1981, the relevant provisions were as follows:

(1) *Eligible employee.*—For purposes of this subpart the term "eligible employee" means an individual—

(A) who has been certified by . . . the appropriate agency of State or local government as—

(i) being eligible for financial assistance under part A of title IV of the Social Security Act and as having continually received such financial assistance during the 90-day period which immediately precedes the date on which such individual is hired by the employer, or

(ii) having been placed in employment under a work incentive program established under section 432(b)(1) of the Social Security Act,

(B) who has been employed by the taxpayer for a period in excess of 30 consecutive days on a substantially full-time basis (except as provided in subsection (i)),

(C) who has not displaced any other individual from employment by the taxpayer, and

(D) who is not a migrant worker.

The provisions did not specify *when* certifications could be requested from the appropriate agencies, however. *See generally* I.R.C. § 50B(h)(1) (1980).

them. In 1985, during an IRS audit of its 1983 return, Albertson's hired a consulting firm to help identify those employees. Albertson's discovered that 121 of its existing employees ("WIN employees") were qualified for the WIN credit program at the time of their hiring. It therefore requested and obtained state-agency certification for those employees during the summer of 1985.

The IRS initially allowed Albertson's to certify its WIN employees retroactively. That is, Abertson's was permitted to submit certifications that it had requested and obtained *after* its WIN empoyees had already started work. The IRS later changed its mind, however, and assessed Albertson's for a tax deficiency of $141,795. Albertson's refused to pay and appealed to the Tax Court. The Tax Court held for the Commissioner, reasoning that Congress had abolished the retroactive certification of WIN employees in 1981. We affirm the judgment of the Tax Court.

2. *Analysis.* Albertson's argues that the Tax Court erred in refusing to allow it to submit certifications that it had requested and obtained after its WIN employees had already started work. We disagree. In 1981, Congress expressly abolished the retroactive certification of WIN credits through the Economic Recovery Tax Act of 1981, Pub.L. 97-34, 95 Stat. 172 ("ERTA").[3] The statute provides that an employee cannot qualify for

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[3] The relevant provisions are currently codified as follows:

(16) Special rules for certifications.—

(A) In general.—An individual shall not be treated as a member of a targeted group unless, *on or before the day on which such individual begins work for the employer,* the employer—

(i) has received a certification from a designated local agency that such individual is a member of a targeted group, or

(ii) has requested in writing such certification from the designated local agency.

See I.R.C. § 51(d)(16) (emphasis added).

WIN-type credits after September 26, 1981, unless his employer requests or obtains state-agency certification "*on or before* the date on which such individual begins work." *See* I.R.C. § 51(d)(16) (emphasis added). Congress imposed this contemporaneous certification requirement because it felt that retroactive certification failed properly to motivate employers to hire WIN-qualified workers and resulted in substantial revenue losses. *See* Staff of the Joint Committee on Taxation, *General Explanation of the Economic Recovery Tax Act of 1981*, at 171 (Joint Committee Print 1981) [hereinafter *Joint Committee Explanation*].[4]

Albertson's argues that another part of ERTA, § 261 (g)(1)(B), creates an exception to the contemporaneous certification rule for all employees who were hired as of January 1, 1982.[5] It bases its argument on a provision

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[4] The current requirements for WIN-type credits are codified as follows:

(9) Eligible work incentive employees.—The term "eligible work incentive employee" means an individual who has been certified by the designated local agency as—

(A) being eligible for financial assistance under part A of title IV of the Social Security Act and as having continually received such financial assistance during the 90-day period which immediately precedes the date on which such individual is hired by the employer, or

(B) having been placed in employment under a work incentive program established under section 432(B)(1) or 445 of the Social Security Act. *See* I.R.C. § 51(d)(9). Technically speaking, WIN-type credits are currently called "targeted jobs credits." In 1981, Congress merged the WIN credit program with the then-existing targeted jobs credit program. It did so in order to prevent confusion among employers. Prior to ERTA, the targeted jobs credit program applied only to groups such as vocational rehabilitation referrals, economically disadvantaged youth, etc. After ERTA, the WIN credit was made part of the targeted jobs credit program. The basic requirements for a WIN-type credit remained the same, however, despite the name change.

[5] Section 261(g)(1)(B) provides as follows:

(B) Eligible Work Incentive Employees. . . . In the case of an eligible work incentive employee, subsections (a) and (b) of sec-

that directs all current WIN employees to be treated "as if such employees had been members of a targeted group for taxable years beginning before January 1, 1982." *Id.* Albertson's argues that because its WIN employees were hired during taxable years beginning before January 1, 1982, the company should be allowed to certify them retroactively for any taxable year beginning after December 31, 1981.

We reject Albertson's reading of section 261(g)(1)(B). That section was enacted simply to ensure that employees who had been hired under the old WIN program would not be treated any differently under the new targeted jobs program. As we explained above, Congress merged the WIN credit with the targeted jobs credit through ERTA, but did not change the basic qualifications for obtaining WIN-type credits. *See* discussion *supra* note 4. Accordingly, Congress wanted to ensure that the former WIN employees were not read out of the statute simply because they were now targeted employees. Section 261(g)(1)(B) does not address in any way the issue of retroactive certification. That determination is left to section 261(g)(2), which clearly abolishes retroactive certification for all claims made after September 26, 1981.[6]

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tion 51 of such Code [establishing the newly expanded targeted jobs credit] shall be applied for taxable years beginning after December 31, 1981, as if such employees had been members of a targeted group for taxable years beginning before January 1, 1982.

[6] The relevant provisions are as follows:

(2) Certifications.—

(A) In general.—The amendment made by subsection (c)(1) shall apply to all individuals whether such individuals began work for their employer before, on, or after the date of the enactment of the Act.

(B) Special rule for individuals who began work for the employer before 45th day before date of enactment.—In the case of any individual . . . who began work for the employer before the date 45 days before the date of the enactment of this Act, [current

Albertson's argument is also refuted by the express language of the act, which unambiguously states that the contemporaneous certification requirement "shall apply to *all individuals* whether such individuals began work for their employer *before, on, or after the date of enactment*." *Id.* § 261(g)(2)(A) (emphasis added). In light of this language, Congress could not have possibly intended a broad-based exception to the contemporaneous certification rule for all employees who had been hired as of January 1, 1982.[7]

In sum, because Albertson's did not claim the WIN credits until after September 26, 1981 (in fact, not until 1985), and because it did not request or obtain state-agency certification until after the start dates of the 121 employees in question, it cannot rely upon retroactive certification for its WIN employees. Accordingly, it is not entitled to the WIN credits.[8]

I.R.C. § 51(d)(16)] shall be applied by substituting "July 23, 1981," for the day on which such individual begins work for the employer.

(C) Individuals who begin work for employer within 45 days before or after date of enactment.—In the case of any individual . . . who begins work for the employer during the 90-day period beginning with the date 45 days before the date of the enactment of this Act . . . [current I.R.C. § 51(d)(16)] shall be applied by substituting "the last day of the 90-day period beginning with the date 45 days before the date of the enactment of this Act" for the day on which the individual begins work for the employer.

See ERTA § 261(g)(2). In effect, the transitional rules allowed retroactive certification for certain requests made on or before September 26, 1981 (which was 45 days after the enactment of ERTA). All requests made after that date—as was the case with Albertson's—were subject to the general rule on contemporaneous certification.

[7] At least one other circuit has held that ERTA abolished the ability of employers to certify their WIN employees retroactively. *See Honeywell, Inc. v. United States*, 973 F.2d 638 (8th Cir.1992).

[8] Albertson's also argues that the Commissioner is bound by a stipulation that precluded any discussion of the effect of ERTA

B. Deferred Compensation Agreements

1. Background. Deferred compensation agreements ("DCAs") are agreements in which certain employees and independent contractors ("DCA participants") agree to wait a specified period of time ("deferral period") before receiving bonuses, salaries, or director's fees for services already rendered ("deferred compensation"). During the deferral period, the employer uses the deferred compensation as an inexpensive source of working capital. At the end of the deferral period, the employer pays the participating individuals the deferred compensation *and* an additional amount ("additional amount") for the time value of the deferred compensation.

Prior to 1982, Albertson's entered into DCAs with eight of its top executives and one outside director. The parties agreed that they would be paid deferred compensation plus an additional amount as calculated by a predetermined formula.[9] The DCA participants would be

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on retroactive certifications. C.R. 21, at ¶ 65. However, it is well established that we are not bound by stipulations as to questions of law. *See Smith Engineering Co. v. Rice*, 102 F.2d 492, 499 (9th Cir.1938), *cert. denied*, 307 U.S. 637, 59 S.Ct. 1034, 83 L.Ed. 1519 (1939) ("We see no reason why we should make what we think would be an erroneous decision, because the applicable law was not insisted upon by one of the parties."). Because the effect of ERTA on retroactive certifications is clearly a question of law, we reject Albertson's argument.

[9] The terms of the eight executives' agreements were as follows:

3.1 The COMPANY agrees to defer payment of certain compensation earned by EMPLOYEE during each fiscal year, such deferred compensation to be paid to EMPLOYEE after EMPLOYEE'S employment is terminated. The compensation to be deferred shall be as set forth . . . below:

. . . .

3.2 The COMPANY agrees to pay to EMPLOYEE a further sum of money equal to the amount of interest accrued which shall be calculated by applying a rate of interest to the total accumulated amount of deferred compensation including accrued interest compounded monthly. The rate to be used will be the weighted

eligible to receive the total sum (the deferred compensation plus the additional amount) upon their retirement or termination of employment with Albertson's. The DCA participants also had the option of deferring payment of the total sum for up to fifteen years thereafter. During that extra period, the additional amounts would continue to accrue on an annual basis.

In 1982, Albertson's requested permission from the IRS to deduct currently the additional amounts (but not the deferred compensation), instead of waiting until the end of the deferral period.[10] In 1983, the IRS granted Albertson's request. Accordingly, Albertson's claimed deductions of $667,142 for the additional amounts that had already accrued, even though it had not yet paid the DCA participants anything. In 1987, the IRS changed its mind, however, and sought a deficiency for those amounts. Albertson's filed a petition with the Tax Court, claiming that the additional amounts constituted "interest" and thus could be deducted as they accrued.

In a sharply divided opinion, the Tax Court rejected Albertson's position. The court found that the additional amounts were not interest, but rather compensation. Under section 404 of the Internal Revenue Code, compensation was not deductible until the end of the deferral period. Accordingly, the court prohibited Albertson's from deducting its expenses relating to the additional amounts until the end of the deferral period. *See Albert-*

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average of the COMPANY'S long term borrowing rate for that current fiscal year.

. . . .

The outside director was paid on his additional amount at a rate equivalent to the rates for new certificates of deposit over $1,000,000 as published in the Wall Street Journal.

[10] In light of the time value of money, it is clearly more advantageous for the taxpayer to take an earlier deduction. Such a deduction reduces the taxpayer's current tax obligations and accordingly allows the taxpayer to invest the assets that he would have otherwise paid to the IRS.

son's, 95 T.C. at 430.[11] We reluctantly reverse the judgment of the Tax Court.

2. Discussion. This issue raises two related questions. First, we must decide whether the tax court erred in finding that the additional amounts were not "interest" within the meaning of the Code. Second, if so, we must decide whether section 404's restrictions against making deductions prior to the end of the deferral period (the "timing restrictions") applied to interest expenses. We answer the first question in the positive and the second in the negative.

a. Albertson's Additional Payments. Albertson's argues that the Tax Court erred in holding that the additional amounts were not "interest" within the definition of I.R.C. § 163. We agree. Section 163(a) allowed a deduction for "all interest paid or accrued within the taxable year on indebtedness." Although neither section 163 nor the regulations relating to it specifically defined "interest," the Supreme Court has held that interest is the measure of the value of the use of money over time. *See Dickman v. Commissioner*, 465 U.S. 330, 337, 104 S.Ct. 1086, 1091, 79 L.Ed.2d 343 (1984). The additional amounts specified in the DCAs were a direct reflec-

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[11] The nine-member majority held that the additional amount was not currently deductible because it was not interest. The four-member concurrence argued that the additional amount was interest, but that section 404's timing restrictions applied to *both* compensation and interest. The five-member dissent argued that the additional amount was interest and that section 404's timing restrictions applied *only* to compensation. One judge did not participate.

Oddly, one member of the court voted both in favor of the majority *and* in favor of the concurrence. This resulted in nine votes in favor of calling the additional amounts "compensation," and nine votes in favor of calling the additional amounts "interest." Because both parties agree that the former position is the "majority" holding of the Tax Court, we accept their characterization throughout this section of the opinion.

tion of what Albertson's would have paid on the open market in order to borrow such amounts. *See* 2 B. Bittker & L. Lokken, *Federal Taxation of Income, Estate and Gifts*, ¶ 60.2.1 (2d ed.1990) (describing the interest component of DCAs, which "reflect[s] the time value of money"). Accordingly, they were a fair measure of the time value of the monies loaned to Albertson's by the DCA participants, and they qualified as interest under the Code.[12]

The Commissioner argues that the additional amounts were not interest because Albertson's never properly "borrowed" the deferred compensation from the DCA participants. According to the Commissioner, Albertson's could not have borrowed the deferred compensation because the DCA participants never had a "legal right to possess" such compensation until the end of the deferral period.[13] We disagree. As the Tax Court concurrence points out, this approach is "anachronistic." *Albertson's*, 95 T.C. at 431 (Halpern, J., concurring).[14] Circuit precedent clearly holds that a legal right to possession of the

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[12] Of course, a taxpayer's characterization of what is "interest" is subject to a rule of reason. Otherwise, most of a taxpayer's obligations under a DCA could be characterized as "interest." We conclude that the interest component in this case is not unreasonable.

[13] This is because the DCA participants are on the cash method of accounting, which means that they do not include the additional amounts as income until it is paid to them at the end of the deferral period.

[14] Indeed, in recent years Congress has aggressively attempted to identify many forms of "hidden" interest. *See, e.g.*, I.R.C. §§ 163(b), 467, 483, 1272, 7872. The Commissioner argues that those provisions can be distinguished in that they all seek to *prevent* tax avoidance. We reject this argument. The government cannot recognize interest when it results in more revenue, but deny it when it results in less. The Commissioner simply cannot have it both ways. Indeed, to deny an interest element in this transaction would be "to stand history on its head." *See Albertson's*, 95 T.C. at 433 n. 4 (Fay, J., dissenting).

assets on which the additional amounts are earned is not necessary in order for those earnings to qualify as interest. For example, in *Starker v. United States*, 602 F.2d 1341 (9th Cir.1979), we recognized interest that accrued in exchange for the ability to make deferred payments over a five-year period. We recognized interest in *Starker* even though the interest payee had no legal right to possess the deferred payments in full until the end of the five-year period. The controlling principle was not possession, but rather "compensation for the use or forbearance of money." *Id.* at 1356. We find this case indistinguishable from *Starker*. Accordingly, the Commissioner's argument fails.

The Commissioner further argues that the additional amounts were not interest, but rather additional deferred compensation. We disagree. The predetermined rate for calculating the additional amounts did not depend in any way upon the amount or type of services performed by the participants. The rate was simply a function of the time that had elapsed since the signing of the DCAs. Under the DCA, participating employees performed the same services and received the same salary as their non-participating colleagues. The only difference between the two groups was the delay in payment and the additional amount received at the end of the deferral period. Accordingly, the additional amounts were not additional compensation, and the Commissioner's argument fails.

Upon a participant's termination of employment with Albertson's, he could still elect to defer payment of the additional amount for up to fifteen years, even though he was no longer providing services to the corporation. Again, the participants were not required to perform any services in return for compensation. The additional amount was calculated at the same rate at which the interest had accrued prior to the employee's termination.

Accordingly, the additional amounts were not compensation, and the Commissioner's argument fails.[15]

The Commissioner finally argues that the additional amounts were not interest because they were not payments for true "indebtedness" by Albertson's. *See* I.R.C. § 163(a) (allowing interest only on payments for "indebtedness"). We disagree. The Tax Court has held that indebtedness is an "unconditional legally enforceable obligation for the payment of money." *Horn v. Commissioner*, 90 T.C. 908, 923, 1988 WL 44098 (1988). In this case, the DCAs were bona fide, nonforfeitable contracts, and Albertson's was unconditionally and legally obligated to pay the DCA participants for deferring their compensation upon the rendering of their services.[16] Accordingly, the additional amounts were payment for indebtedness, and the Commissioner's argument fails.

b. Section 404 and Interest Expenses. Having held that the additional amounts are interest within the meaning of section 163, we now turn to the question whether the timing restrictions of section 404 applied to interest expenses—in other words, did section 404 prohibit Albertson's from deducting such expenses prior to the time the participants were required to recognize the ad-

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[15] The Commissioner responds by arguing that the additional amounts were compensation because the DCA participants agreed to provide "advisory and consulting services" for as long as they chose to defer payment. This argument fails, however, because the participants were not required to perform any specific services and because the rate at which the additional amounts were calculated was identical to the pre-termination interest rate.

[16] The Commissioner cites *Deputy v. du Pont*, 308 U.S. 488, 497, 60 S.Ct. 363, 368, 84 L.Ed. 416 (1940) for the proposition that "an obligation is not necessarily an 'indebtedness' within the meaning of § 23(b) [the predecessor of § 163]." *Du Pont* is not instructive, however, because it involved an obligation by the taxpayer to return certain shares of stock that it had borrowed from the lender. The obligation incurred in *du Pont* did not involve the time value of money.

ditional amounts as income? Based on a plain-language reading of the statute in effect during the taxable year at issue, we conclude that the answer is no—the timing restrictions did not apply to interest expenses. Albertson's was therefore free to deduct such expenses as they accrued. Accordingly, we reverse the judgment of the Tax Court.

Prior to 1942, corporations were allowed to deduct DCA-related expenses as they accrued each year, even though employees did not recognize any income until a subsequent taxable year. In 1942, Congress abolished this preferential treatment for certain deductions relating to "unqualified" DCAs such as the ones at issue in this case.[17] In so doing, Congress forced employers to wait until the *end* of the deferral period before they could deduct expenses relating to their unqualified DCAs. *See* I.R.C. §§ 404(a)(5) & 404(d) (1983).[18] This is be-

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[17] Unqualified plans are those that, among other things, discriminate in favor of highly compensated employees. *See* I.R.C. § 401(a)(4). Albertson's concedes that the DCAs at issue in this case are not qualified plans.

[18] The relevant provisions, at the time Albertson's filed its 1983 tax return, were as follows:

Sec. 404. Deduction for . . . compensation under a deferred-payment plan.

(a) General rule.— . . . . [I]f compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such . . . compensation shall not be deductible under section 162 (relating to trade or business expenses) or section 212 (relating to expenses for the production of income); but if they satisfy the conditions of either of such sections, they shall be deductible . . .

(5) . . . in the taxable year in which an amount attributable to the contribution is includible in the gross income of employees participating in the plan. . . .

(d) Deductibility of payments of deferred compensation, etc., to independent contractors.—If a plan would be described [as above]. . . . [the] compensation—

cause section 404 of the Code prohibited an employer from deducting certain expenses until they were includible in the income of the DCA participants, which was usually not until the end of the deferral period.[19] *See id.*

In the taxable year at issue, the Code and regulations specified two categories of deductions to which the timing restrictions of section 404 applied. First, section 404 applied to section 162 deductions, *see* I.R.C. § 162, which included "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." *See* I.R.C. § 404(a)(5) (1983). Second, section 404 applied to section 212 deductions, *see* I.R.C. § 212, which included "all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income." *See id.; see generally* Treas.Reg. § 1.404(a)-1(b) (1983).[20]

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(1) shall not be deductible by the payor thereof under section 162 or 212, but

(2) shall . . . be deductible under this subsection for the taxable year in which an amount attributable to the . . . compensation is includible in the gross income of the persons participating in the plan.

Id.

[19] Most individuals are on the cash accounting system and thus would not include the income from their DCAs until it is paid to them in full.

[20] The relevant provisions were as follows:

(b) In order to be deductible under section 404(a), contributions must be expenses which would be deductible under section 162 (relating to trade or business expenses) or 212 (relating to expenses for production of income) if it were not for the provision in section 404(a) that they are deductible, if at all, only under section 404(a). Contributions may therefore be deducted under section 404(a) *only* to the extent that they are ordinary and necessary expenses [incurred] during the taxable year in carrying on the trade or business or for the production of income and are compensation for personal services actually rendered.

Id.

The interest accrued under the DCAs in this case did not fall within either of the above categories. Interest deductions, which included "all interest paid or accrued within the taxable year on indebtedness," were covered by section 163 of the Code. *See* I.R.C. § 163. They were not subject to either section 162 or section 212. *Compare* I.R.C. § 163 (pertaining to interest) *with* I.R.C. §§ 162 & 212 (not pertaining to interest). Because we must not "add to or alter the words employed to effect a purpose which does not appear on the face of the statute," *Hanover Bank v. Commissioner*, 369 U.S. 672, 687, 82 S.Ct. 1080, 1089, 8 L.Ed.2d 187 (1962), we hold that, in the taxable year at issue, the timing restrictions of section 404 were inapplicable to interest deductions.

The legislative history of section 404 lends support to our conclusion. There is absolutely no indication that Congress intended section 404 to apply to interest deductions. Section 404 was codified in its present form in 1954. At that time, Congress was fully aware of the differences between the predecessors to sections 162 (trade or business expenses), 163 (interest), and 212 (production of income expenses) of the Code. *See, e.g.*, H.R.Rep. No. 1337, 83d Cong., 2d Sess., *reprinted in* 1954 U.S.C.C.A.N. 4017, 4181 (discussing the relationship between the predecessors to sections 162, 163, and 212). If Congress had intended section 404 to govern the timing of interest deductions, it could have made specific reference to the predecessor of section 163 as well. *See, e.g.*, I.R.C. § 267 (1983) (explicitly referring to section 163 as well as sections 162 and 212). To the contrary, the legislative history of section 404 mentions only "compensation." *See, e.g.*, S.Rep. No. 1631, 77th Cong., 2d Sess. (1942), *reprinted in* 1942-2 Com.Bull. at 504, 607-09. Accordingly, there is no indication in the legislative history of section 404 that Congress intended it to apply to interest.

The Commissioner argues that a 1986 "clarifying" amendment to section 404, which eliminated the references to sections 162 and 212 in order to make clear the broad scope of the statute, evidenced Congressional intent, *ab initio*, to include interest under that section. We reject this argument. According to the legislative history of the 1986 amendment, it is true that Congress intended to clarify section 404 to include all forms of *compensation* for services rendered. However, there is insufficient indication that Congress intended to include anything *other than compensation. See, e.g.*, S.Rep. No. 313, 99th Cong., 2d Sess. 1, 1013 (1986) (referring repeatedly to compensation).[21] As we have noted, for DCA purposes, "compensation" and "interest" are two very different concepts. Accordingly, we reject the Commissioner's argument that the 1986 amendment evidenced an intent by Congress to include interest expenses under the timing restrictions of section 404.

Finally, the Commissioner argues that, notwithstanding the plain language of the statute, Congress must have intended to include interest expenses within the scope of section 404 because Congress enacted timing restrictions with respect to compensation expenses. We do not agree

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[21] The relevant provisions are as follows:

b. Clarification of the scope of the deduction-timing rules applicable to *deferred compensation* arrangements. . . .

Explanation of Provision

The bill clarifies that the deduction-timing rules for *deferred compensation* arrangements apply to any plan or method of deferring *compensation* regardless of the section under which the amounts might otherwise be deductible and that the amount shall be deductible under section 404(a)(5) and shall not otherwise be deductible under any other section. This clarification is necessary to prevent taxpayers from asserting that *deferred compensation* is attributable to capitalizable compensation expenses [*e.g.*, under section 263A enacted in 1986] and, thereby, accelerate the timing of the deduction for such *deferred compensation.*

Id. (emphasis added).

that simply because Congress determined to treat compensation in a particular manner it necessarily intended to treat interest in that same manner. Congress' decisions with respect to tax policy do not always fit a neat and logical pattern. Sometimes they are even influenced by less-than-objective forces. Still, we sympathize with the Commissioner's "policy" arguments regarding Congress' intent. It is quite possible that, had Congress considered this problem in 1942 and 1986, it would have modified the wording of section 404 to cover deductions for interest as well as for compensation. Permitting the deduction of interest may simply have resulted from a glitch in the Code. Even if that is the case, however, Code changes are for Congress to make—not the courts.

In sum, we hold that the timing restrictions of section 404 do not apply to expenses relating to interest that is paid pursuant to a DCA. Accordingly, Albertson's may properly deduct such expenses as they accrue, and we reverse the Tax Court on this issue.

C. HVAC Systems Credits

1. Background. Prior to 1986, the Internal Revenue Code allowed a tax credit for a taxpayer's investment in certain types of property ("Section 38 Property"). *See* I.R.C. § 46 (1983).[22] In general, such property did not include "structural components" of buildings, such as central air conditioning or heating systems. *See* Treas. Reg. § 1.48-1(e)(2). A limited exception for such systems existed, however, if the "sole justification" for them was meeting the temperature and humidity requirements essential for the operation of other machinery. *See id.*[23]

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[22] The investment tax credit was repealed by section 211 of the Tax Reform Act of 1986, Pub.L. No. 99-514, 100 Stat. 2085.

[23] Treas.Reg. § 1.48-1(e)(2) provides as follows:

[T]he term "structural components" does not include machinery the *sole justification* for the installation of which is the fact that such machinery is required to meet temperature or humidity

The owner of systems that qualified under the exception were able to claim investment tax credits for such property.

In 1985, Albertson's claimed investment tax credits for various heating, ventilating, and air conditioning ("HVAC") systems that it had installed in 33 of its supermarkets. Albertson's argued that it was entitled to the investment tax credits because the "sole justification" for such property was meeting the temperature and humidity requirements for Albertson's refrigerated cases and computerized checkout equipment. The Tax Court agreed and ruled in Albertson's favor. We reverse.

2. *Analysis.* The Commissioner argues that the Tax Court clearly erred in holding that the "sole justification" for Albertson's installation of its HVAC systems was the meeting of the temperature and humidity requirements for its other machinery We agree. The Tax Court erred by failing to recognize that the HVAC systems were intended for and are used by Albertson's for two additional significant purposes: ventilation and customer comfort.

First, Albertson's HVAC systems play an important role in ventilating its supermarkets. The Tax Court completely failed to recognize this point. Albertson's HVAC systems provide a continuous supply of fresh air to its supermarkets. The systems also remove airborne bacteria, smoke, dirt, and stale odors. Because customer concerns about cleanliness are a top priority for supermarkets, Albertson's HVAC systems are crucial for attracting and retaining customers in a highly competitive

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requirements which are essential for the operation of other machinery or the processing of materials or foodstuffs. Machinery may meet the "sole justification" test even though it incidentally provides for the comfort of employees, or serves, to an insubstantial degree, areas where such temperature or humidity requirements are not essential.

Id. **(emphasis added).**

market. Even Albertson's acknowledges that it is "certainly only good business practice" to ventilate its supermarkets. In light of these facts, we conclude that Albertson's HVAC systems play an important role in ventilating its supermarkets.

Second, HVAC systems clearly provide a comfortable shopping environment for Albertson's customers. The systems are set to 72°F all year round, which is well within the optimum comfort range for individuals of 68°F to 78°F. Given the broad geographical range of stores throughout Albertson's chain of supermarkets (Florida to Idaho), we find it impossible to say that air conditioning during the summer and heating during the winter does not result in a more comfortable shopping environment for the taxpayer's customers. This conclusion is supported by the fact that, during the 1950s, Albertson's had already installed HVAC systems in most of its supermarkets, well before it was aware of any interrelationship between HVAC systems and the proper functioning of its other equipment.

Given these facts, we conclude that it was clear error for the Tax Court to find that meeting the temperature and humidity requirements for other machinery was the "sole justification" for Albertson's installation of its HVAC systems.

Albertson's argues that customer comfort is a permissible exception to the "sole justification" test. That is, the HVAC systems are not disqualified even though they result in customer comfort. Specifically, Albertson's argues that the regulatory exception for *employee* comfort, *see* Treas. Reg. § 1.48-1(e)(2), is equally applicable to customer comfort. We decline to adopt Albertson's expansive reading of the regulation. First, the plain language of the regulations indicates that the comfort exception applies only to *employees*; the regulations make no reference to any other groups of individuals. Second,

the example immediately following the regulation shows that the IRS intended the employee comfort exception to be a narrow one. *See id.* (giving the example of a factory—where there are no customers—instead of a retail store). Accordingly, we decline to import the concept of "customer" into the word "employee." [24]

In sum, because Albertson's HVAC systems clearly provide for ventilation and customer comfort, we reject its argument that the "sole justification" for such systems is maintaining the temperature and humidity requirements for its other machinery. Although such maintenance might very well be a *primary* reason for installing the HVAC systems, it is not the *only* significant one. Accordingly, the HVAC systems do not fall within the "sole justification" exception for central air conditioning or heating systems, *see* Treas.Reg. § 1.48-1(e)(2), and Albertson's is not eligible to claim tax credits for such property.[25]

III. CONCLUSION

The judgment of the Tax Court is AFFIRMED in part and REVERSED in part.

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[24] Albertson's argues that a narrow reading of the "employee comfort" exception would result in the unavailability of the exception in any work environment in which inspectors, auditors, union stewards, and similar persons are present. We disagree. Our holding applies only to work environments in which *customers* are present. The IRS has stated that the occasional presence of other individuals would not result in a disqualification of the air conditioning equipment. We agree.

[25] Albertson's also relies upon *Piggly Wiggly Southern, Inc. v. Commissioner*, 803 F.2d 1572 (11th Cir.1986), in which the Eleventh Circuit held that costs for a similar HVAC system qualified for an investment tax credit. We decline to follow the Eleventh Circuit's holding. Instead, we agree with the Court of Claims, which held that HVAC systems are not eligible for investment tax credit treatment. *See Publix Supermarkets, Inc. v. United States*, 26 Cl.Ct. 161 (1992).

APPENDIX C

UNITED STATES TAX COURT

Docket No. 10439-87

ALBERTSON'S, INC.,
Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

Filed October 9, 1990

RUWE, *Judge:* * Respondent determined a deficiency in petitioner's Federal income tax in the amount of $718,936 for fiscal year ending February 3, 1983. Originally, three issues were presented for decision: (1) The investment tax credit issue; (2) the WIN credit issue; and (3) the interest/deferred compensation issue. By an order dated December 27, 1988, this Court severed the investment tax credit issue from the other issues and decided it in petitioner's favor. See *Albertson's, Inc. v. Commissioner*, T.C. Memo. 1988-582. Supplemental briefs with respect to the WIN credit and the interest/deferred compensation issues were ordered filed. We subsequently separated the two remaining issues and decided the WIN credit issue in respondent's favor. See *Albertson's, Inc. v. Commissioner*, T.C. Memo. 1990-153. This opinion involves the interest/deferred compensation issue. Spe-

* By Order of the Chief Judge, this case was reassigned to Judge Robert R. Ruwe for purposes of opinion.

cifically, we address whether the amounts designated as interest under petitioner's deferred compensation arrangements are deductible in the year accrued. Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect for the year in issue. All Rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts and attached exhibits are incorporated herein by this reference.

Petitioner, a Delaware corporation, had its principal place of business in Boise, Idaho, at the time the petition in this case was filed. During the year in issue, petitioner operated over 400 retail food and drug stores in the Western, Southern, and Southeastern United States. Petitioner is an accrual basis taxpayer.

Prior to the fiscal year in issue, petitioner established nonqualified deferred compensation arrangements (DCA's) for eight "key" executives (employees DCA's) and for one outside member of its board of directors (director DCA). The executives and the director participating in the DCA's will be referred to as DCA participants. The DCA's were unfunded and represented the unsecured contractual obligations of petitioner to pay a specified sum, determined in accordance with the terms of each DCA, to each DCA participant at or after a specified time. The time specified was retirement, termination of employment, or, in the case of the outside director, age 72. Petitioner's purpose in establishing the DCA's and offering them to its executives and directors was to attract and retain the services of qualified persons for those positions.

Under the DCA's, petitioner and the DCA participants agreed to defer payments for future personal services the DCA participants would otherwise have been entitled to

receive in the year they performed said services. The agreement was struck as a result of arm's-length negotiations conducted prior to the year personal services were performed. Each participant in an employee DCA deferred either a specified portion of his or her future salary or an annual bonus, or both. The participant of the director DCA deferred 100 percent of his monthly retainer fees and board and committee meeting fees.

Prior to the beginning of a fiscal year of petitioner, each DCA participant could elect not to participate in his or her respective arrangement for that year. If a DCA participant elected not to participate, his or her compensation for the year would not be deferred and would actually be paid to him or her as earned.

Petitioner maintained bookkeeping accounts to calculate the deferred personal service compensation of each DCA participant. The accounts for each DCA participant reflected the amount of compensation that was originally deferred plus an amount designated as "interest." For the year in issue, the provisions defining deferred compensation that were contained in the employee DCA's were as follows: [1]

> 3. DEFERRED COMPENSATION:
>
> 3.1 The COMPANY agrees to defer payment of certain compensation earned by EMPLOYEE during each fiscal year, such deferred compensation to be paid to EMPLOYEE after EMPLOYEE'S employment is terminated. The compensation to be deferred in each fiscal year shall be as set forth in subparagraphs (a) and (b) below:
>
> (a) The sum of $———. This amount will be prorated for any partial fiscal year upon retirement or termination.

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[1] The DCA entered into by petitioner and Paul W. Mouser varies somewhat, but contains substantially similar language.

(b) The bonus earned by EMPLOYEE for such fiscal year pursuant to any bonus plan or plans then in effect unless EMPLOYEE, by written notice to the Secretary of the COMPANY prior to the beginning of any fiscal year, elects to have only a portion of such bonus deferred for such fiscal year. In such event, the portion of such bonus which EMPLOYEE elects not to be deferred shall be paid in accordance with the provisions of the bonus plan.

3.2 The COMPANY agrees to pay to EMPLOYEE a further sum of money equal to the amount of interest accrued which shall be calculated by applying a rate of interest to the total accumulated amount of deferred compensation including accrued interest compounded monthly. The rate to be used will be the weighted average of the COMPANY'S long term borrowing rate for that current fiscal year.

3.3 As used in Section 3.2 above, "total accumulated amount of deferred compensation" means compensation deferred pursuant to previous deferred compensation agreements between the COMPANY and EMPLOYEE (including phantom stock agreements) as well as this agreement.

3.4 For purposes of this agreement a "year" is defined as a "fiscal year" coincident with the COMPANY'S fiscal year.

With respect to the director's DCA, the interest component was also compounded monthly, but was determined by reference to the Wall Street Journal and the rate there quoted as being paid by major banks on new issues of negotiable certificates of deposit in amounts of $1 million or more. The DCA participants' rights to receive payment under the DCA's could not be commuted, encumbered, assigned, or otherwise disposed of.

For taxable years prior to the year in issue, petitioner did not claim a deduction with respect to its DCA's interest component unless a deduction was permitted by section 404(a) by reason of the amount actually being paid and included in the gross income of the recipient.[2] On June 14, 1982, petitioner filed with respondent a request for a change of accounting method with respect to its DCAs' interest component. Petitioner requested it be allowed to account for the interest component by deducting it in the year accrued rather than the year paid. On August 26, 1983, respondent issued a letter permitting petitioner to change, as requested, its method of accounting for its DCAs' interest component. The change year involved was the year in issue, petitioner's fiscal year ending February 3, 1983.

Relying on the permission granted, petitioner compounded and accrued on a monthly basis the interest component of the DCA's with respect to each DCA participant's accumulated account balance. Petitioner treated this amount separately as an "interest expense" for purposes of its fiscal year 1983 consolidated earnings statement. On its Federal income tax return for the year in issue, petitioner claimed an interest expense deduction in the amount of $667,142 for the DCA's interest component accruing during the year.

By notice of deficiency dated March 6, 1987, respondent determined that his August 26, 1983, letter permitting petitioner an accounting method change would be revoked under section 7805(b) retroactive to the date

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[2] As discussed more fully *infra*, sec. 404(a)(5) and (d) prohibits an employer from deducting amounts of deferred compensation accrued under a nonqualified DCA until those amounts are included in the plan participant's gross income. All participants in petitioner's DCA's (DCA participants) were cash basis taxpayers and would recognize as gross income the amounts accruing under their DCA's in the year those amounts are actually or constructively received.

of its issuance. Based on his retroactive revocation, respondent disallowed the deduction petitioner claimed with respect to the DCA's interest component for the year in issue because no interest was actually paid during the year.

As originally presented for trial, the interest/deferred compensation issue involved three questions:

(1) Whether respondent acted properly in revoking retroactively his permission for petitioner to change its method of accounting for the DCA's interest component (the retroactive revocation question);

(2) Whether the DCA's interest component actually constitutes "interest" within the meaning of section 163; and

(3) If the amounts in question are interest, whether section 404(5) and (d) proscribes their deduction.

When called for trial on May 23, 1988, the Court, on its own motion, severed the retroactive revocation question from the remainder of this case and took it under advisement. Thereafter, a trial was held and evidence was presented only with respect to the other issues remaining for decision. At the trial's conclusion, this case stood submitted.

Upon further consideration, the Court decided to take evidence on the retroactive revocation question so it could be decided along with all other issues previously submitted. Accordingly, trial of the retroactive revocation question was scheduled for December 18, 1989. On that date, a pretrial conference was held with counsel for petitioner and respondent. During the conference, the parties' positions with respect to the retroactive revocation question were discussed at length. Petitioner's counsel averred petitioner, after further consideration, did not desire to pursue any relief with respect to the retroactive revocation question. Petitioner's counsel was given an

opportunity to again consult with petitioner. When this case was recalled from the calendar later in the day, petitioner's counsel read into the record a statement concerning petitioner's understanding of the consequences of its abandonment of the retroactive revocation question. The parties then filed a stipulation of settled issues. By these actions, petitioner effectively conceded the retroactive revocation question scheduled to be tried.

OPINION

We must now decide the remainder of the interest/deferred compensation issue. Specifically, we address whether the amount designated as interest under the DCA's is "interest" within the meaning of section 163. If it is interest, we must also decide whether it is deductible in the year accrued.

Respondent argues that the amount designated as interest under the DCA's is not interest. Instead, respondent contends that the amounts in question represent additional deferred compensation for personal services, deductible only as permitted by section 404(a)(5) or (d). Respectively, that section permits deduction of deferred compensation only when the compensation is includable in the income of an employee or independent contractor. Respondent further argues that even if the amounts in question are found to constitute interest within the meaning of section 163, section 404(a)(5) and (d) still controls when these amounts may be properly deducted.

Petitioner concedes that if the amounts in issue represent compensation for personal services, section 404(a)(5) and (d) controls, and the amounts in question are deductible only in the year they are actually paid to the DCA participants. Petitioner argues, however, that the amounts in question are not deferred compensation for personal services. Instead, petitioner contends that these amounts represent interest within the meaning of section 163. Furthermore, petitioner asserts that if the amounts

in question constitute interest, section 404(a)(5) and (d) is inapplicable and the interest is deductible as accrued.

Our first inquiry is whether the amounts in question represent interest or compensation for personal services. In answering this question, we must consider all relevant facts and circumstances and make our determination based on the substance of the transaction and not the form in which it is cast. *Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1945); *Gregory v. Helvering*, 293 U.S. 465 (1935).

Interest is "the amount which one has contracted to pay for the use of *borrowed* money." (Emphasis added.) *Old Colony Railroad Co. v. Commissioner*, 284 U.S. 552, 560 (1932). Interest is also commonly defined as "compensation for the use or *forbearance* of money." (Emphasis added.) *Deputy v. du Pont*, 308 U.S. 488, 498 (1940). Interest is the equivalent of "rent" for the use of funds. *Dickman v. Commissioner*, 465 U.S. 330, 339 (1984). Implicit in these three definitions of interest is the concept that interest is a payment for the use of money that the lender had the legal right to possess, prior to relinquishing possession rights to the debtor.[3]

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[3] The terms borrow, forbearance, and rent are commonly defined as follows:

> Borrow. To solicit and receive from another any article of property, money or thing of value with the intention and promise to repay or return it or its equivalent. If the item borrowed is money, there normally exists an agreement to pay interest for its use. In a broad sense the term means a contract for the use of money. * * * [Black's Law Dictionary 167 (5th ed. 1979).] Forbearance. Act by which creditor waits for payment of debt due him by debtor after it becomes due. * * * A delay in enforcing rights. * * * [Black's Law Dictionary 580 (5th ed. 1979).]
>
> Rent. Consideration paid for use or occupation of property. * * * [Black's Law Dictionary 1166 (5th ed. 1979).]

One of the principal advantages of deferred compensation plans is that participants are allowed to defer taxes on the deferred compensation until the year of actual receipt. Contracts deferring the right to receive compensation that are entered into *prior* to the performance of the services for which the compensation is being paid have been recognized for purposes of determining when income is received for Federal income tax purposes. In such cases, the contract controls the employee's right to receive payment. It is the absence of any legal right to receive compensation in the year in which the DCA participants rendered services that precludes recognition of income in that year. *Basila v. Commissioner,* 36 T.C. 111, 116-117 (1961); *Gann v. Commissioner,* 31 T.C. 211, 217 (1958); *Oates v. Commissioner,* 18 T.C. 570, 585 (1952), affd. 207 F.2d 711 (7th Cir. 1953).[4]

The participants in petitioner's deferred compensation plans agreed to defer either a portion of their salary, or a bonus, or both. (The plan for the corporate director deferred 100 percent of his monthly retainer fee, board meeting fees, and committee meeting fees.) They entered into these agreements prior to rendering any services for petitioner and, therefore, never had a legal right to be paid any of the deferred compensation in the year they rendered services. Likewise, petitioner was not under, and never had been under, any legal requirement to pay the deferred amounts to the DCA participants in the year they performed services or during any subsequent year prior to their retirement, termination, or attainment of a specified age.[5] Petitioner was always the "owner"

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[4] See Rev. Rul. 60-31, 1960-1 C.B. 174, modified by Rev. Rul. 64-279, 1964-2 C.B. 121 and Rev. Rul. 70-435, 1970-2 C.B. 100.

[5] It cannot be argued that the DCA participants were in "constructive receipt" of the deferred compensation. There can be no constructive receipt until the contractual conditions giving rise to a present right to payment are met. *Basila v. Commissioner,* 36 T.C. 111, 115-118 (1961). See *Cohen v. Commissioner,* 39 T.C. 1055, 1063 (1963).

of the money involved in these plans. See *Goldsmith v. United States*, 218 Ct. Cl. 387, 397 (1978).

The amounts recorded in the bookkeeping accounts as "interest" do not represent payments made by petitioner for the use of money "borrowed" from its employees and director. Nor do these amounts constitute liabilities owed to the DCA participants for the "forbearance" of money whose payment had become due. In determining the effect of a transaction for income tax purposes, formalities such as nomenclature and bookkeeping entries are not controlling. *Gregory v. Helvering, supra; Doyle v. Mitchell Bros. Co.*, 247 U.S. 179, 187 (1918). The important consideration is substance, not form. *Wood v. Commissioner*, 93 T.C. 114, 120 (1989); *U.S. Asiatic Co. v. Commissioner*, 30 T.C. 1373, 1381 (1958). The fact that certain amounts are described as interest by the parties to an agreement and are calculated by applying a percentage rate per annum to some principal amount does not mean that the amounts will be deductible as interest for income tax purposes. *Autenreith v. Commissioner*, 115 F.2d 856, 858 (3d Cir. 1940), affg. 41 B.T.A. 319 (1940).

DCA participants never had any legal basis to demand payment of the deferred amounts, and petitioner never had an obligation to pay deferred compensation in the year in issue. Petitioner could not have "borrowed" something from the DCA participants that the DCA participants never had the right to possess. One cannot forgo something to which one *never* had a right. One cannot lend that which one *never* had a right to possess, and petitioner cannot *borrow* money that it *always* had the right to possess. Petitioner cannot properly characterize its accruals as "interest." [6]

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[6] Were we to accept the rationale that deferred compensation that an employee never had a present right to receive is, in substance, the same as a loan from the employee to the employer, it would seem to follow that such a characterization would be required

Petitioner's purpose in offering to defer compensation was to remain competitive within the executive and director recruitment marketplace. Executives and directors are paid compensation in return for services and are free to enter into contracts specifying the timing and amounts of compensation.[7] The amount of deferred compensation to be paid an employee can, and often is, related to the date on which the employee is entitled to payment. Under such an arrangement, the time value of money affects the amount of compensation to be paid under the contract. B. Bittker & L. Lokken, Federal Taxation of Income, Estate, and Gifts, par. 60.2.1, p. 60-10, 60-11 (2d ed. 1990). The fact that these same economic considerations are used to determine interest rates cannot transform a portion of the deferred payment into "interest." Likewise, an amount computed on the basis of interest rates does not automatically transform the amount being computed into "interest." For example, the fact that the value of a gift resulting from an interest-free or below-market loan is measured by interest is not the same as actually charging or paying interest. *Estate of Arbury v. Commissioner*, 93 T.C. 137 (1989). "[A] donor who loans money in an interest-free demand loan has not charged interest on that loan; nor has the donee paid interest. Rather, the donor has simply made a gift

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whether or not the deferred compensation plan included an "interest" factor. Using this approach, it would logically follow that a deferred compensation arrangement that had no interest factor would be treated as an interest-free loan within the terms of sec. 7872, and that the employee would have to report an amount representing interest as taxable income during each year of deferral. Secs. 7872 and 1272. An amount representing taxable interest income would thus be imputed to the employee even though the employee never had a right to receive the principal amount of the deferred compensation and was not required to recognize the principal amount as taxable income. Surely, this was not a result desired by Congress.

[7] We doubt that the opportunity to lend one's employer money at market rates would normally be considered a recruitment device.

to the donee, the value of which will be determined by the interest rate." *Cohen v. Commissioner*, 910 F.2d 422, 428 (7th Cir. 1990), affg. 92 T.C. 1039 (1989). For the same reasons, a deferred compensation plan that uses interest rates to compute the amount of deferred compensation plan benefits does not result in the accrual of deductible "interest." [8]

In holding that petitioner incurred no liability for "interest," we do not mean to imply that petitioner had not incurred a bona fide obligation to compensate the DCA participants. However, as the Supreme Court stated in *Deputy v. du Pont*, 308 U.S. at 497, "although an indebtedness is an obligation, an obligation is not necessarily an 'indebtedness' within the meaning of sec. 23(b) [the predecessor of sec. 163]." In *Deputy v. du Pont, supra*, the taxpayer had borrowed shares of stock and had agreed to return the shares within 10 years and to pay the lender an amount equivalent to all dividends on the stock during the period of the loan, plus any taxes incurred by the lender as a result of the arrangement. The taxpayer sought to deduct these latter amounts as interest. In holding that the amounts in issue were not interest, the Court stated:

> In *Old Colony Railroad Co. v. Commissioner*, 284 U.S. 552, this Court had before it the meaning of the word "interest" as used in the comparable provision of the 1921 Act (42 Stat. 227). It said, p. 560, ". . . as respects 'interest,' the usual import of the term is the amount which one has contracted to pay for the use of borrowed money." It there

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[8] Bittker gives several examples showing the economic and tax impact of deferred compensation plans on the employer and employee. In the examples, the amount of the employee's deferred benefits is calculated by using prevailing interest rates. In each of the examples, it is assumed, without discussion, that the "interest factor" is not deductible until the benefits are actually paid to the employee. B. Bittker & L. Lokken, Federal Taxation of Income, Estates, and Gifts, par. 60.2.1, p. 60-11, 60-12 (2d ed. 1990).

> rejected the contention that it meant "effective interest" within the theory of accounting or that "Congress used the word having in mind any concept other than the usual, ordinary and everyday meaning of the term." p. 561. It refused to assume that the Congress used the term with reference to "some esoteric concept derived from subtle and theoretic analysis." p. 561.
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> We likewise refuse to make that assumption here. It is not enough, as urged by respondent, that "interest" or "indebtedness" in their original classical context may have permitted this broader meaning. We are dealing with the context of a revenue act and words which have today a well-known meaning. In the business world "interest on indebtedness" means compensation for the use or forbearance of money. * * *
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> [*Deputy v. du Pont, supra* at 497-498. Fn. refs. omitted.]

For reasons previously explained, petitioner did not borrow money from the DCA participants. At the time the DCA's were entered into, the DCA participants had no right to money which could be the subject of their forbearance. After they performed services called for by the DCA's, they still had no money or immediate right to receive money which could have been the subject of their forbearance during the year in issue. Rather, the amounts accrued as "interest" were an integral part of the method used by petitioner to calculate the total amount of deferred compensation to be paid to the DCA participants. As compensation, deductibility is governed by the provisions of section 404 relating to employee benefit plans.

Employers may take immediate deductions for contributions actually made to "qualified plans." Strict requirements must be met to achieve qualified status. The most significant of these requirements relate to the fund-

ing of benefits, minimum coverage, prohibitions against discrimination, limitations on the benefits which may accrue to participants, and prohibitions against self-dealing. Secs. 401(a), 410, 411, 412, 415, and 4975. Qualified deferred compensation arrangements are subject to funding requirements imposed under the Internal Revenue Code and the Employee Retirement Income Security Act of 1974 (ERISA). Secs. 404(a) and 412; 29 U.S.C. sec. 1082 (1988). An employer that contributes to a qualified plan must pay the contributions to a trustee under a trust arrangement or to an insurance company that issues an annuity contract with respect to the plan. With respect to the requirement in section 404(a) that there be an actual payment, the Supreme Court has stated:

> This accords, also, with the apparent policy behind the statutory provision, namely, that an objective outlay-of-assets test would insure the integrity of the employees' plan and insure the full advantage of any contribution which entitles the employer to tax benefit. [*Don E. Williams Co. v. Commissioner*, 429 U.S. 569, 579 (1977). Fn. ref. omitted.]

Contributions to qualified plans are held and invested by the trustee or insurance company until the time of distribution to the employee. The assets contributed to the trustee or insurance company cease to be assets of the employer and are not subject to the debts, obligations, and creditors of the employer. The income earned on these assets is not taxable to either the trustee, the insurance company, or the employer, and the employee incurs no tax as a result of participation in a qualified plan until the time benefits are received.

Under section 404, compensation paid or accrued pursuant to a nonqualified plan is not deductible until includable in the income of the plan participants.[9]

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[9] SEC. 404. DEDUCTION FOR CONTRIBUTIONS OF AN EMPLOYER TO AN EMPLOYEES' TRUST OR ANNUITY

Prior to the Revenue Act of 1942, deferred compensation was deductible under section 23(a) as an ordinary and necessary business expense in the year it was paid or incurred. See *Oxford Institute v. Commissioner*, 33 B.T.A. 1136 (1936). Payments made to qualified plans were also deductible under section 23(p). *Tavannes Watch Co. v. Commissioner*, 176 F.2d 211 (2d Cir. 1949), revg. 10 T.C. 544 (1948). Because of consider-

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PLAN AND COMPENSATION UNDER A DEFERRED-PAYMENT PLAN.

(a) GENERAL RULE.—If contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan, or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under section 162 (relating to trade or business expenses) or section 212 (relating to expenses for the production of income); but, if they satisfy the conditions of either of such sections, they shall be deductible under this section, subject, however, to the following limitations as to the amounts deductible in any year.

* * * *

(5) OTHER PLANS.—If the plan is not one included in paragraph (1), (2), or (3), in the taxable year in which an amount attributable to the contribution is includible in the gross income of employees participating in the plan, but, in the case of a plan in which more than one employee participates only if separate accounts are maintained for each employee.

* * * *

(d) DEDUCTIBILITY OF PAYMENTS OF DEFERRED COMPENSATION, ETC., TO INDEPENDENT CONTRACTORS.—If a plan would be described in so much of subsection (a) as precedes paragraph (1) thereof (as modified by section (b)) but for the fact that there is no employer-employee relationship, the contributions or compensation—

(1) shall not be deductible by the payor thereof under section 162 or 212, but

(2) shall (if they would be deductible under section 162 or 212 but for paragraph (1)) be deductible under this subsection for the taxable year in which an amount attributable to the contribution or compensation is includible in the gross income of the persons participating in the plan.

able abuse, Congress amended section 23(p) of the 1939 Code in 1942. Section 23(p), as amended in 1942, expanded the types of qualified plans which were covered by the provision, and for the first time included nonqualified deferred compensation plans. Under section 23(p), no deductions were allowed until payments were actually made, regardless of whether or not an employer was a cash basis or an accrual basis taxpayer. Sec. 23 (p)(1); *New York Post Corp. v. Commissioner,* 40 T.C. 882, 886-887 (1963). The committee reports indicate that Congress intended to make section 23(p) the exclusive section under which items of this nature would be allowed as a deduction. H. Rept. 2333, 77th Cong., 2d Sess. (1942), 1942-2 C.B. 372, 451; S. Rept. 1631, 77th Cong., 2d Sess. (1942), 1942-2 C.B. 504, 607. See *Wesley Heat Treating Co. v. Commissioner,* 30 T.C. 10, 22-23 (1958), affd. 267 F.2d 853 (7th Cir. 1959); *Times Publishing Co. v. Commissioner,* 13 T.C. 329, 335 (1949), affd. per curiam 184 F.2d 376 (3d Cir. 1950). Section 23(p) was reenacted as section 404 in the 1954 Code in essentially the same form. *Don E. Williams Co. v. Commissioner,* 429 U.S. at 579-580.

Petitioner's position runs counter to the statutory scheme. It would allow taxpayer-employers to characterize portions of deferred compensation benefits as interest, thereby providing an employer with current tax deductions for a part of the deferred compensation benefits without meeting the strict requirements necessary to assure the actual receipt of benefits by the participants. If the employer's credit rating degenerated, making it less likely that the employee would ever receive benefits, there would be greater justification for a higher rate of "interest." If this "interest" element were deductible, the amount of deductions generated by nonqualified deferred compensation plans would increase in direct proportion to the risk that the employee might ultimately receive nothing. The deductible "interest" element would often exceed the original amount of deferred compensation.

See B. Bittker & L. Lokken, Federal Taxation of Income, Estates, and Gifts, par. 60.2.1, pp. 60-10-60-12 (2d ed. 1990). Such a result would be contrary to the legislative objective of section 404. See *Don E. Williams Co. v. Commissioner, supra* at 579-580.

When section 404 was amended in 1978, Congress indicated that section 404 was applicable to any "method of * * * compensation having the effect of a plan deferring the receipt of compensation." H. Rept. 95-1800 (Conf.) (1978), 1978-3 C.B. 805. Petitioner's plan came within this broad sweep as would an employee pension plan. The Employee Retirement Income Security Act of 1974 (ERISA) defines the term "pension plan" as follows:

> (2)(A) Except as provided in subparagraph (B), the terms "employee pension benefit plan" and "pension plan" mean any plan, fund, or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both, to the extent that by its express terms or as a result of surrounding circumstances such plan, fund, or program—
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> (i) provides retirement income to employees, or
>
> (ii) results in a deferral of income by employees for periods extending to the termination of covered employment or beyond,
>
> regardless of the method of calculating the contributions made to the plan, the method of calculating the benefits under the plan or the method of distributing benefits from the plan.
>
> [29 U.S.C. sec. 1002 (1988).]

Petitioner's DCA's resulted in the deferment of income by its employees. The benefits under the DCA's were based upon the initial amount of compensation that was deferred and the period of the deferral. For practical

and legal purposes, petitioner's plan could also be described as a pension plan.[10] See *Springfield Productions Inc. v. Commissioner*, T.C. Memo. 1979-23. If petitioner's plans had been described as pension plans instead of deferred compensation plans, section 404(a) would specifically preclude petitioner from deducting its obligations under the DCA's until the employer's "contributions" had been paid and were includable in the employees' incomes. The only "contributions" to be paid pursuant to petitioner's plans would be the ultimate payment of benefits to participating employees. Acceptance of petitioner's theory, that part of the plan benefits are attributable to accrued interest on deferred compensation, would mean that an employer's ability to take current deductions in connection with a nonqualified deferred compensation arrangement would be dependent on the title of the plan, rather than its substance.

Another reason why deductions attributable to petitioner's DCA's should be limited to amounts actually paid and includable in the gross income of receipts can be inferred from the literal provisions of section 404. Section 404(a) provides that "If *contributions are paid*" under certain types of designated plans (including pension plans) or "if *compensation is paid or accrued* on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under section 162" but shall be deductible under section 404(a). (Emphasis added.) Both parties agree that the timing of deductions for the employees' deferred "compensation" in this case is controlled by section 404(a)(5). Section 404(a)(5) provides that deductions are to be taken "in the taxable year in which

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[10] While the DCA's come within the definition of a "pension plan," ERISA provides a specific exemption from the coverage and funding requirements of ERISA for "a plan which is unfunded and is maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees." 29 U.S.C. secs. 1051(2) and 1081(a)(3) (1988).

an amount attributable to the *contribution* is includable in the gross income of employees participating in the plan." (Emphasis added.) Section 404(a)(5) makes no reference to "compensation." It simply provides for deduction by the employer in the year the "amount attributable to the *contribution*" is reportable by the employee. Throughout section 404, the term "contribution" is used in conjunction with the word "paid," and it is clear that unless there is an actual outlay of funds by an employer, there is no "contribution" within the meaning of section 404(a)(5). The only payments pursuant to the DCA's were to be made upon the employee's retirement or termination. Query: What is the "contribution" or "amount attributable to the contribution" in petitioner's plan that will trigger deductibility under section 404(a)(5)? If petitioner's plan does not call for a "contribution," the literal provisions of section 404(a)(5) would never be triggered and the deferred compensation would never be deductible. The answer is that petitioner's "contribution" under the employee DCA's is the total payment to the employee upon retirement or termination. Under section 404(a)(5), a "contribution" is only deductible when it is includable in the gross income of the employee. The "contribution" and "compensation" pursuant to petitioner's DCA's, are identical just as petitioner's DCA's can be defined as either pension plans or deferred compensation plans within the meaning of section 404(a).

The "interest" factor in petitioner's DCA's is not interest within the meaning of section 163. Rather, it is part of the deferred compensation. It is therefore deductible only as permitted under section 404(a)(5) and (d). To allow petitioner to characterize part of the deferred compensation plan benefits as "interest" and deduct that amount in the year credited to the participants' accounts would be contrary to the legislative purpose of section 404.

Decision will be entered under Rule 155.

Reviewed by the Court.

NIMS, PARKER, KORNER, HAMBLEN, CLAPP, JACOBS, GERBER, and COLVIN, *JJ.*, agree with the majority opinion.

WHALEN, *J.*, did not participate in the consideration of this opinion.

HALPERN, *J.*, concurring: I concur with the result reached by the majority, but I disagree, in part, with the majority's analysis. I do not think that the case turns on whether the "interest" component of the deferred compensation represents payments made by petitioner for the use of money "borrowed" from its employees and director. A central focus of the time value of money legislation of the last 10 years was to identify hidden interest. Congress clearly understood that transactions involving deferred payments for services contained an interest element.[1] Thus, given our current understanding of the interest element inherent in deferred payment transactions, the majority's analysis seems anachronistic. Moreover, had the participants in the deferred compensation arrangements here in question computed their taxable income under the accrual method of accounting, thus being required to take into income their "base" compensation in the year earned (notwithstanding its deferred receipt), would the majority still maintain that the "interest" element accruing each year did not, indeed, constitute interest for Federal income tax purposes? The majority's conclusion that no payments of interest are being made is dependent on its prior conclusion that the petitioner had not borrowed anything from its employees and director. I do not see how that prior conclusion can turn on the accounting method of petitioner's employees and director.[2]

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[1] See, e.g., S. Rept. 98-169 (Vol. 1), at 249-250 (1984) ("Present law provides exceptions to the rules requiring annual recognition and deduction of OID for the following: * * * (6) obligations issued in exchange for services. fn. * * * Present law is unclear as to whether all deferred payments for services are within the scope of sections 404 and 404A.")

[2] Those individuals computed taxable income under the cash method of accounting. As a result, they do not, for tax purposes, realize income prior to receipt. Perhaps, then, for tax purposes, it could be said that, since they have received nothing, they have nothing to lend. Such an analysis, although helpful on a theoretical level, does not, I believe, aid in the problem of statutory construction here presented.

The inquiry as to whether petitioner has, in a property law sense, borrowed anything from its employees and director is, I believe, not a helpful inquiry. The proper inquiry, I believe, is whether deductibility of the "interest" component of the deferred payment is governed by section 404. I believe that it is. With regard to nonqualified deferred compensation, the plain purpose of section 404 is to require matching of income inclusion and deduction as between the employee and employer.[3] Subsection (a) of section 404 disallows a deduction under the normal rules of deductibility and tax accounting for compensation the receipt of which is deferred. However, if such compensation otherwise would be deductible, the subsection allows a deduction under the special rules found in section 404. Subsection (a)(5) provides a limitation on the amount deductible in any year in connection with a nonqualified plan deferring the receipt of compensation. In pertinent part, it provides for a deduction in the taxable year in which an amount attributable to the compensation is includable in the gross income of an employee participating in the plan. Section 1.404(a)-12(b)(2) of the income tax regulations illustrates the application of section 404 with regard to the payment of unfunded (nonqualified) pensions. In pertinent part, it states: "If unfunded pensions are paid directly to former employees, such payments are includible in their gross income when paid, and accordingly, such amounts are deductible under section 404(a)(5) when paid."[4] It would be unusual for a pension plan not to have an investment (or "interest") element to it, yet the regulation unambiguously allows a deduction *equal* to the pension payment only when such payment is includable in gross

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[3] See H. Rept. 2333, 77th Cong., 1st Sess. (1942), 1942-2 C.B. 372, 451-452; S. Rept. 1631, 77th Cong., 2d Sess. (1942), 1942-2 C.B. 504, 609.

[4] Compare sec. 1.404(a)-12(b)(1), which describes a deduction equal only to the employer's contribution to the plan but, apparently, deals only with a funded plan.

income. I see no reason why a different rule should apply to the payments of deferred compensation here in question. Whether the parties label a portion of the payments interest does not matter. To allow an accrual method employer to deduct interest in advance of inclusion by employees would frustrate the matching principle apparent in the statute. It can be said that the effect of that matching principle is that the employer is being taxed in substitution for not currently taxing the employee.[5] If the employer were allowed an interest deduction, then the present discounted value of the tax burden on the employer would not be equivalent (i.e., would be less than) an immediate tax on the employee (assuming, of course, equal tax rates).[6] We need not allow that result.

HAMBLEN, COHEN, and PARR, *JJ.*, agree with this concurring opinion.

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[5] See Halperin, "Interest in Disguise: Taxing the 'Time Value of Money,'" 95 Yale L.J. 506, 520.

[6] See the discussion in Halperin, *supra* at 519-524.

FAY, *J.*, dissenting: I respectfully disagree with the majority opinion of this Court. The majority held the amounts in question are not interest and further concluded even if these amounts are interest, the deduction is limited by sections 404(a)(5) and 404(d). I find the amounts in question are interest and are deductible as permitted by section 163, without limitation by sections 404(a)(5) or 404(d).

As the majority correctly pointed out (majority op. at 419), this Court severed the retroactive revocation issue,[1] holding a trial only with respect to the interest characterization and deductibility issues. At trial both parties expended substantial time and energy presenting evidence with regard to the interest issue, and at the trial's conclusion, this case stood submitted. As trier of fact I found the amounts in question to be interest.

Upon further consideration, this Court decided to take evidence on the arbitrary retroactive revocation issue. I set the case for a second trial in Boise, Idaho. However, when the case was called from the calendar, petitioner conceded the arbitrary retroactive revocation issue.[2] This concession involved a substantial sum of money amounting to hundreds of thousands of dollars. Petitioner, in the presence of respondent, disclosed in great detail to the Court the reasons for conceding the revocation issue. The abandonment of that claim highlights the importance petitioner placed on obtaining a definitive determination on the interest characterization and deductibility issues.[3]

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[1] On June 14, 1982, petitioner submitted to respondent a request for a change in method of accounting (from cash to accrual) for the interest element of the DCA. On Aug. 26, 1983, respondent granted petitioner's request for a change of accounting method. On Jan. 29, 1986, respondent revoked its letter granting approval of petitioner's change of accounting method.

[2] The parties presented nc new evidence concerning the interest characterization and deductibility issues.

[3] The extensive amicus brief filed by Northwest Mutual Insurance Co. highlights the importance other taxpayers place on these issues.

Factually, the amounts deferred under the DCA's must be interest. "[I]nterest is * * * paid because of delay in the receipt of funds." *Ames v. Commissioner*, 94 T.C. 189, 193 (1990). Under the facts of the instant case, it is obvious the additional amounts accrued under the DCA's were accrued because of delay in the receipt of funds. While I do not quarrel with the majority's definition of interest, the majority's finding the amounts are not interest is contrary to the facts of this case.[4]

A common fact pattern is useful to illustrate this point.

> B wants to purchase a piece of real property from S. The property has a value of $45,000. B cannot pay the full purchase price immediately. S and B enter into a contract on January 1, 1983. S agrees to transfer title and possession to B on February 1, 1983. B agrees to pay S $10,000 upon transfer of title plus $100,000 due in ten years. B and S agree the $100,000 is comprised of $35,000 towards the purchase price and $65,000 of interest (10.5% compounded daily).

This example is indistinguishable from the facts of the instant case. In the example, S transferred the real property to B, thus providing the consideration that gave rise to S's *immediate right to the delayed payment* from B. In the instant case, the employees and directors transferred to petitioner their promises of services and their actual performances of services.

It is important to stress that, in both the example and the instant case, the seller (whether of realty or services) *never* had the right to *current possession* of the buyer's funds. Yet the majority apparently would concede that there has been a forbearance in the example. There is the same forbearance in the instant case.

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[4] In recent years Congress has been attempting to identify hidden interest. See secs. 163, 467, 483, 1272, and 7872. To deny an interest element in this transaction would be to stand history on its head.

The majority's discussion of constructive receipt (majority op. at 422) appears to be accurate, but it is quite irrelevant to the disupute before us. In neither the example nor in the case before us has there been constructive receipt; in both there has been forbearance that should lead to the conclusion that the disputed amounts are interest.

One final note on the interest issue, we find the majority's reliance on *Goldsmith v. United States,* 218 Ct. Cl. 387, 586 F.2d 810, 816 (1978), and *Oates v. Commissioner,* 18 T.C. 570, 585 (1952), affd. 207 F.2d 711 (7th Cir. 1953), puzzling at best. Neither case involved the deduction side of the transaction and neither dealt with the interest element of deferral plans.

Having found the amounts in question are interest, the statute is clear: the deduction is not limited by sections 404(a)(5) and 404(d), and the majority offers no support for its contrary conclusions. In his concurring opinion, Judge Halpern argues that allowing an employer to deduct interest in advance of inclusion by employees frustrates the matching principle, but it is the prerogative of Congress, not this Court, to change the statuory resul of section 404(a)(5).

Section 404(a)(5) limits deduction of only those amounts described under section 404(a). Sec. 1.404(a)-12(a), Income Tax Regs. Section 404(a)(5) in relevant part provides:

> SEC. 404(a). GENERAL RULE.— * * * if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such * * * compensation shall not be deductible under section 162 (relating to trade or business expenses) or section 212 (relating to expenses for the production of income); but, if they satisfy the conditions of either of such sections, they shall be deductible under this section, subject, how-

> ever, to [certain] limitations as to the amounts deductible in any year: * * *

By reading section 404(a) as prohibiting deductions otherwise permitted by section 163, the majority opinion effectively amends section 404(a) to read as follows:

> if compensation is paid or accrued *(or if interest or other earnings on such compensation is paid or accrued)* on account of any employee under a plan deferring the receipt of such compensation, such * * * compensation shall not be deductible under section 162 (relating to trade or business expenses), *section 163 (relating to interest expenses)* or section 212 (relating to expenses for the production of income) * * *

Such judicial amendments of the statute are improper, ill-advised, and imprudent. "It is best, we may observe, where the laws are enacted upon right principles, that everything should, as far as possible, be determined absolutely by the laws, and as little as possible left to the discretion of the judges." Aristotle (384-322 B.C.), The Rhetoric, bk. 1, ch. I (J.E. Welldon trans.). Moreover, such an amendment is *contrary to regulations* issued by the Secretary of the Treasury on the proper application of section 404(a). Section 1.404(a)-1(b), Income Tax Regs., summarizes the requirements for a deduction under 404(a) as follows:

> Contributions may * * * be deducted under section 404(a) *only to the extent that they are ordinary and necessary expenses* during the taxable year in carrying on the trade or business or for the production of income *and are compensation for personal services actually rendered.* [Emphasis added.]

Based on these regulations, section 404(a) limits deduction of "*only * * * compensation for personal services actually rendered.*" The deferred amounts accruing under petitioner's DCA's are in part deferred compensation

for personal services and in part interest. Therefore, petitioner may deduct the interest portion as it accrues under the DCA plan.

Further support for deductibility can be found in section 1.404(a)-12(b)(1), Income Tax Regs. That regulation concerns the application of section 404(a)(5) and provides as follows:

> (b) Contributions made after August 1, 1969—(1) In general. A deduction is allowable for a contribution paid after August 1, 1969, under section 404(a)(5) only in the taxable year of the employer in which or with which ends the taxable year of an employee in which an amount attributable to such contribution is includible in his gross income as compensation, and then only to the extent allowable under section 404(a). See sec. 1.404(a)-1. *For example, if an employer A contributes $1,000 to the account of its employee E for its taxable (calendar) year 1977, but the amount in the account attributable to that contribution is not includible in E's gross income until his taxable (calendar) year 1980 (at which time the includible amount is $1,150), A's deduction for that contribution is $1,000 in 1980 (if allowable under section 404 (a)).*[5] [Emphasis added.]

Thus, in his own regulations, the Secretary of the Treasury applies section 404(a)(5) to limit *only* the $1,000 contribution for personal services. While the additional $150 is not specifically identified in the example, it is accepted practice for an employer to accrue interest with respect to compensation deferred under a DCA.[6]

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[5] The Commissioner approved of this treatment in granting permission to petitioner to change his method of accounting. This permission was later retroactively revoked.

[6] See also B. Bittker & L. Lokken, Federal Taxation of Income, Estates, and Gifts, par. 60.2.1, p. 60-11, (2d ed. 1989) *"To reflect*

Implicitly, an accrual method employer may deduct the $150 interest component as that interest accrues.

In accordance with the foregoing, I would find the amounts in question are interest and are deductible under section 163, without limitation by sections 404(a)(5) and 404(d).

CHABOT, SWIFT, WRIGHT, and WELLS, *JJ.*, agree with this dissenting opinion.

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the time value of money, deferred compensation agreements often inflate the amount to be paid, either implicitly (by designating a sum larger than would be reasonable if the compensation were paid immediately) or explicitly (by crediting the employee's account with *interest* at a specified annual rate). [Emphasis added]. See also N. Mancoff & D. Weiner, Nonqualified Deferred Compensation Arrangements, sec. 10.04 at 14-15, and sec. 10.09 at 30 (1987); Rev. Rul. 60-31, 1961-1 C.B. 174; Rev. Rul. 69-650, 1969-2 C.B. 106; and Rev. Rul. 71-419, 1971-2 C.B. 220.

APPENDIX D

UNITED STATES TAX COURT

Docket No. 10439-87

T.C. Memo. 1988-582

ALBERTSON'S, INC.

v.

COMMISSIONER

Filed December 27, 1988

MEMORANDUM FINDINGS OF FACT AND OPINION

FAY, Judge: Respondent determined a deficiency of $718,936 in Federal income tax for petitioner's taxable year ending February 3, 1983. The issue for decision is whether central heating, ventilating, and air-conditioning systems installed by petitioner in thirty-three of its stores qualified as section 38 [1] property for investment tax credit purposes.[2]

[1] Unless otherwise noted, all section references are to the Internal Revenue Code of 1954, as amended, and in effect during the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

[2] By Order, dated this date, the Court, on its own motion, has severed the remaining issues in the case for purposes of opinion and additional briefing on these issues.

FINDINGS OF FACT

Some of the facts have been stipulated. The facts set forth in the stipulations and attached exhibits are incorporated herein by this reference.

Petitioner, an accrual basis taxpayer, was a Delaware corporation operating over 400 retail food and drug stores throughout the western, southern, and southeastern regions of the United States during the year at issue. Petitioner's principal place of business at the time the petition herein was filed was in Boise, Idaho.

During the fiscal year ending February 3, 1983, petitioner purchased and installed heating, ventilating and air-conditioning (HVAC) systems in 13 of its remodeled, and 20 of its new, retail food stores. Each of the HVAC systems at issue consisted of a central air handler, compressor, condensor, cooling coils and heat reclaim coils, all of which were connected to a system of duct-work and diffusers. Petitioner's HVAC systems operated 24 hours a day, including hours its stores were closed to customers and employees.

In order for petitioner to achieve high volume sales and to remain competitive with other retail food stores, petitioner sold refrigerated and frozen food products in all of its retail food stores, and used computerized checkout systems [3] at many of its stores. In fact, because of competition from other retail food stores, if petitioner did not have refrigerated food cases and, thereby, have available for sale its refrigerated food products, petitioner would have been out of business in a short period of time. Petitioner displayed the majority of its refrigerated and, frozen food products in open-front, as opposed to closed, refrigerated food cases.[4] Petitioner's open-front cases

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[3] The computerized checkout systems consist of several components which include an electronic cash register, a scale, a display, and a scanner device.

[4] Petitioner's open-front cases were manufactured by a variety of corporations and were of the following types: (1) meat; (2)

were located throughout each store and its computerized checkout systems were located at its checkout counters.

Manufacturers designed their cases to operate properly in stores where temperature and relative humidity were strictly maintained according to certain specifications. All of the manufacturers' specifications for the cases used by petitioner recommended an ambient store environment at or below 75 degrees Fahrenheit and at or below 55 percent relative humidity. No cases were available which had lower environmental specifications. The manufacturers of petitioner's computerized checkout systems recommended specifications for an ambient store environment of 50 to 104 degrees Fahrenheit and 5 to 90 percent relative humidity.

Historically, retail food stores, such as those owned by petitioner, developed a need for HVAC systems with the development and installation of open-front refrigerated food cases. As open-front cases began to proliferate throughout the retail food industry, it was discovered that there was an interaction between a store's environment, the functioning of open-front cases, and the refrigerated environment within open-front cases. Icing of coils in open-front cases occurred when the relative humidity within the store increased above a certain level. Icing of coils was a problem that affected the proper mechanical functioning of open-front cases, which in turn caused spoilage. Moreover, it also became apparent that the quality of food displayed in open-front cases could also be adversely affected if a retail food store's ambient temperature became too high, even if the open-front cases themselves did not malfunction due to icing.

Increased ambient store temperatures and relative humidity levels can affect food quality by causing shelf life of refrigerated food products in open-front cases to decrease, thus causing those refrigerated products to be

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frozen food; (3) deli; (4) produce; (5) service meat and fish; (6) service deli; (7) an ice cream dipping cabinet; and (8) dairy.

adversely affected. Shelf life is the amount of time that a product will remain acceptable to a customer, given specified storage temperatures. To insure the effective use of its HVAC system in preserving refrigerated food products, petitioner's maintenance manual for its stores for the year at issue provided as follows:

> *Heating, Ventilating, and Air-Conditioning Systems*
>
> 1. Temperature Settings—
>
> a. Leave the thermostat set at 72 degrees position all year, as *any deviation may adversely affect the condition of perishable foods.* [Emphasis supplied.]
>
> b. The heating or air-conditioning systems will automatically turn on, depending upon which system is needed.
>
> c. If it is necessary to change the thermostat setting, contact the service technician.
>
> d. Prohibit employees from changing the thermostat setting.
>
> e. Governmental energy saving proclamations may from time to time alter this thermostat setting, and you will be notified in writing describing the adjustment necessary.

Studies show that variances in the temperature at which a particular refrigerated food product is displayed can have a direct adverse effect on the quality of such product by shortening the product's shelf life. Further, it is generally accepted that increases in ambient store temperatures above case manufacturers' specifications cause temperature increases within open-front cases which are designed to keep the temperature of the food displayed therein at a specific temperature. Consequently, if the retail store's temperature is not constantly maintained within case specifications, then case temperatures cannot be constantly maintained and the food displayed therein will suffer a shortened shelf-life.

As an example, the shelf life of meat products in any of petitioner's open-front meat cases is directly influenced by the temperature of the air therein. Meat that is displayed at an internal case temperature of 32 degrees Fahrenheit has a shelf life that lasts many days longer than meat that is maintained at a temperature a few degrees higher. If the store environment is not controlled by a HVAC system, and if the temperature of the store increases above that specified by the case manufacturer, the temperature within the meat case will also rise and will no longer be optimal for extended shelf life of meat products which will spoil more quickly. Similarly, shelf life of frozen food products is decreased by an occurrence known as "freezer burn." "Freezer burn" is caused by fluctuations in ambient store temperature above case manufacturer's specifications which cause temperature fluctuations within open-front frozen food cases. As the temperature of frozen foods fluctuates, this causes many food products to dehydrate causing "freezer burn." Thus, the failure to use a HVAC system can easily result in lost product sales, and profits.

In order to maintain a strictly controlled ambient store environment that is below 75 degrees Fahrenheit and 55 percent relative humidity, as recommended by the open-front case manufacturers, petitioner, like most food retailers, installed a HVAC system in each of its stores to reduce relative humidity and temperature fluctuations. However, during the summer months, the outdoor temperatures at the locations of petitioner's stores at issue would often reach or be in excess of 90 degrees Fahrenheit. The variance in petitioner's store temperature and the outdoor temperature created discomfort to many customers who complained to petitioner's employees that the stores were uncomfortably cold. Nevertheless, petitioner could not raise its store temperature to accommodate its customers without risking spoilage of its refrigerated food products displayed in open-front cases.

In 1979, the Department of Energy (DOE) issued proposed energy conservation regulations which prohibited business establishments from heating their premises above 65 degrees Fahrenheit or cooling their premises below 80 degrees Fahrenheit. These regulations created an exemption for retail food stores. The prefacatory discussion accompanying the proposed DOE regulations, 44 Fed. Reg. 31,927-31,928 (1979), explains:

> In formulating the provisions relating to general exemptions for classes of uses within covered buildings, DOE has sought to carry out the Plan's objectives of achieving significant and immediate reduction in energy demand while avoiding severe economic loss or serious hazards to health. Thus, the exemptions in the proposed regulations focus on these areas; *no exemptions based solely on personal comfort are included.* [Emphasis supplied.] * * *
>
> * * *
>
> Proposed section 490.31(a)(3) is intended to avoid health hazards where certain temperature and humidity levels are required for the proper storage and handling of food and other agricultural commodities. By way of illustration, this section would exempt supermarkets and grocery stores where temperature and humidity levels other than those mandated in the regulations are required to preserve produce or for the proper refrigeration of perishable items on open shelf units.

Respondent submitted expert witness reports prepared by Robert Reynolds, a private consultant in marketing economics, and Richard Calvert, a mechanical engineer who participated in the design of HVAC systems for 12 stores between 1959 and 1969. Mr. Reynold's report quotes from a 1963 book, Modern Supermarket Operation, which made the following observations about the importance of air conditioning in a retail food store:

> A few years ago, air conditioning was considered a luxury. Since that time, supermarket operators have

> come to the conclusion that they pay for air conditioning whether they use it or not. Loss of sales volume and increased spoilage of perishable foods during the hot months are direct business losses resulting from lack of air conditioning; often these losses exceed the cost of an air conditioning unit. Consequently, *air conditioning is* now standard equipment in supermarkets. [Emphasis supplied in report.]

F. Brand, Modern Supermarket Operation (2d ed. 1963).

Petitioner did not claim investment tax credits on its HVAC systems placed in service for the year at issue on its Federal corporate income tax return for such year. Rather, petitioner raised the issue of its entitlement to such credits subsequently, during an examination by respondent. The amount of investment tax credits to be allowed petitioner, should the Court determine that petitioner is entitled to such credits for the HVAC systems, has been stipulated by the parties. The parties have aso stipulated that petitioner will be entitled to additional cost recovery deductions for the HVAC systems under section 168 if petitioner prevails on the investment tax credit issue.

OPINION

The issue for decision is whether the HVAC systems installed in petitioner's retail food stores qualify as section 38 properly for investment tax credit purposes. Section 38 allows a credit against tax for investments in certain types of property, described as "section 38 property." Section 38 property includes, in relevant part, "Tangible personal property (other than an air-conditioning or heating unit)." The parties dispute whether petitioner's HVAC systems installed in its retail food stores are tangible personal property within the meaning of section 48(a)(1)(A) and the regulations promulgated under that section.

Although section 48(a)(1)(A) explicitly makes reference to "an air-conditioning or heating unit," respondent has not argued that the HVAC systems at issue come within the parenthetical language of section 48(a)(1)(A). In *Piggly Wiggly Southern, Inc. v. Commissioner* [Dec. 42,039], 84 T.C. 739, 755 (1985), affd. [86-2 USTC ¶ 9789] 803 F.2d 1572 (11th Cir. 1986), this Court held that the legislative intent behind the parenthetical language was that the investment tax credit would be denied only in the case of *portable* air conditioners and heaters. Respondent makes no contention that petitioner's HVAC systems are portable air conditioners and heaters.

The regulations provide guidance as to the meaning of "tangible personal property" within the meaning of section 48(a)(1)(A). Section 1.48-1(c), Income Tax Regs., provides in pertinent part:

> For purposes of this section, the term "tangible personal property" means any tangible property except land and improvements thereto, such as buildings or other inherently permanent structures (including items which are structural components of such buildings or structures). Thus, buildings, swimming pools, paved parking areas, wharves and docks, bridges, and fences are not tangible personal property. Tangible personal property includes all property (*other than structural components*) which is contained in or attached to a building. [Emphasis supplied.]

Accordingly, petitioner's HVAC systems are tangible personal property qualifying for the investment tax credit if they are not "structural components."

The term "structural components" is defined in section 1.48-1(e)(2), Income Tax Regs., as follows:

> The term "structural components" includes such parts of a building as walls, partitions, floors, and

> ceilings, as well as any permanent coverings therefor such as panelling or tiling; windows and doors; all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts; * * * and other components relating to the operation or maintenance of a building. *However, the term "structural components" does not include machinery the sole justification for the installation of which is the fact that such machinery is required to meet temperature or humidity requirements which are essential for the operation of other machinery or the processing of materials or foodstuffs. Machinery may meet the "sole justification" test provided by the preceding sentence even though it incidentally provides for the comfort of employees, or serves, to an insubstantial degree, areas which such temperature or humidity requirements are not essential.* For example, an air conditioning and humidification system installed in a textile plant in order to maintain the temperature or humidity within a narrow optimum range which is critical in processing particular types of yarn or cloth is not included within the term "structural components." * * * [Emphasis added.]

Section 1.48-1(e)(2), Income Tax Regs., represents an accurate interpretation of congressional intent with respect to HVAC systems and has the full force and effect of law. *Piggly Wiggly Southern, Inc. v. Commissioner, supra*; *Fort Walton Square, Inc. v. Commissioner* [Dec. 30,031], 54 T.C. 653 (1970). The parties agree that the HVAC systems are "structural components" not eligible for the investment tax credit unless the HVAC systems qualify under the "sole justification" test of section 1.48-1(e)(2), Income Tax Regs.

This Court has recently decided a case, *Piggly Wiggly Southern, Inc. v. Commissioner, supra,* which respondent acknowledges is very similar, factually, to the instant case.

Piggly Wiggly Southern, Inc. v. Commissioner, supra, involved an investment tax credit issue arising out of HVAC systems utilized in retail food stores owned by Piggly Wiggly Southern, Inc. In that case, we made a factual determination that "the sole justification for the installation of the HVAC units in [the taxpayer's] stores was that the HVAC units were essential to meet the temperature or humidity requirements for the operation of [the taxpayer's] refrigeration equipment, and the benefit to [the taxpayer's] workers and customers was incidental," at 753. Respondent argues that the record presented by petitioner is factually distinguishable from the record presented in *Piggly Wiggly Southern, Inc. v. Commissioner, supra.* We disagree.

Respondent's only contention is that petitioner's HVAC systems do not meet the "sole justification" test. Petitioner contends that its *sole justification* for installing the HVAC systems in its stores was to meet the temperature and relative humidity requirements of its open-front refrigerated food cases and its computerized checkout systems. While respondent agrees that petitioner's retail food stores require HVAC systems to keep ambient store temperature within case manufacturers' specifications and prevent spoilage, respondent contends that a substantial reason for installing HVAC systems was to provide customer and employee comfort. Respondent relies on its two experts and their submitted reports in support of this contention. We do not find respondent's experts persuasive in support of this proposition because many of the authorities relied upon by respondent's experts do not directly support the expert's conclusion that the sole justification for installing HVAC systems was not that the HVAC systems were essential to meet the specifications for petitioner's open-front cases.

In support of its contention with respect to the open-front cases, respondent asserts that retail food stores, to remain competitive, require an ambient store environment that is comfortable to its customers and employees. Re-

spondent further asserts that the manufacturers designed their refrigerated cases so that such cases could operate in an environment that is comfortable to customers. Respondent contends that manufacturers could have designed the cases to operate properly optimally at lower "uncomfortable" store temperatures. However, respondent asserts that since the retail food industry had established a comfortable environment for its customers and employees as a standard, cases were designed to fit that standard. Therefore, respondent concludes that the justification for the installation of the HVAC systems was also to provide a comfortable environment to customers and employees and not solely for the operation of its cases.

First, we find fault with respondent's premise that the cases always operated at a "comfortable" ambient store temperature. During periods of the year outdoor temperatures substantially exceeded the strictly maintained store temperature; it caused the store temperature to be uncomfortably cold to many of its customers. Second, if the case manufacturers' justification for its specifications was to permit petitioner to maintain comfortable store temperatures and relative humidity levels, petitioner was still required to install HVAC systems in order to control the interaction between the ambient store environment and the internal case environment by not exceeding case manufacturers' specifications. If specifications were exceeded, petitioner's refrigerated food inventory would spoil. This strict 24 hour control of store environment was even recognized by the DOE as a factor in issuing an exemption for retail food stores from its energy conservation measures. The fact that manufacturers may have designed their cases so they could generally be operated in a "comfortable" ambient environment was an incidental benefit to petitioner. As the Court in *Piggly Wiggly Southern, Inc. v. Commissioner, supra* at 753 observed:

> It is bootstrapping to argue, post hoc ergo propter hoc, that where a collateral benefit necessarily fol-

lows an action, that the collateral benefit belies another basis as the justification for the action.

* * *

Petitioner was involved in a competitive industry and was extremely sensitive to the fact that if it did not maintain case manufacturers' specifications for store environment, whatever those specifications may be, the quality of its food products displayed in its open-front cases would suffer, resulting in lost product, sales, and profits. It was for this reason that it was crucial to the operation of each of petitioner's retail food stores that each had a HVAC system. Given that case manufacturer specifications permitted petitioner to both maintain its stores at a temperature and relative humidity suitable for proper case performance *and* a degree of customer comfort, the fact that petitioner chose an environment for its stores that attempted to achieve *both* only makes sense. Any additional incidental benefit to customers and employees does not belie petitioner's sole justification for installing the HVAC systems—i.e., to maintain its cases and thus preserve the quality of its food products.

Based on a review of the evidence, we conclude that the sole justification for the installation of the HVAC systems was to maintain the specifications recommended for the proper operation of petitioner's open-front cases. We hold that petitioner's HVAC systems meet the exception to the term "structural components" contained in section 1.48-1(e)(2), Income Tax Regs. Accordingly, petitioner's HVAC systems at issue are tangible personal property under section 48(a)(1)(A) and qualify as section 38 property for investment tax credit purposes.[5]

To reflect the foregoing, and footnote 2, *supra*,

An appropriate order has been issued.

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[5] We need not address petitioner's argument that the HVAC systems were also installed to meet the temperature and humidity requirements of its computerized checkout systems. Failure to prove this would not establish that the HVAC systems were installed for customer and employee comfort.

APPENDIX E

UNITED STATES TAX COURT

Docket No. 10439-87

T.C. Memo. 1990-153

ALBERTSON'S, INC.

v.

COMMISSIONER

Filed March 21, 1990

MEMORANDUM FINDINGS OF FACT AND OPINION

FAY, Judge: Respondent determined a deficiency in petitioner's Federal income tax for its fiscal year ending February 3, 1983, in the amount of $718,936. Originally, three issues were presented for decision: (1) the investment tax credit issue; (2) the WIN Credit issue; and (3) the deferred compensation/interest issue. By an Order dated December 27, 1988, we severed the investment tax credit issue from the other two issues and decided that issue in petitioner's favor. See *Albertson's, Inc. v. Commissioner* [Dec. 45,236(M)], T.C. Memo. 1988-582. Supplemental briefs with respect to the WIN Credit and deferred compensation/interest issues were ordered filed. For convenience, we separate the two remaining issues and here decide only the WIN Credit issue. More specifically, we decide whether petitioner is entitled to claim tax credits, determined under

sections 40, 50A, and 50B [1], with respect to wages paid to certain of its employees previously on welfare or hired pursuant to a work incentive program. Our decision of the deferred compensation/interest issue will be forthcoming in a separate opinion of this Court.

FINDINGS OF FACT

Some of the facts have been stipulated. The Stipulations of Fact and attached exhibits are incorporated by reference.

During the year at issue, petitioner, Albertson's, Inc., was an accrual basis taxpayer operating over 400 retail food and drug stores in the western, southern, and southeastern United States. Petitioner, a Delaware corporation, had its principal place of business in Boise, Idaho, at the time the petition in this case was filed.

Petitioner's taxable year at bar ended February 3, 1983. On March 26, 1984, respondent initiated an audit (the Audit) of petitioner's corporate income tax return for that fiscal year. The Audit did not conclude until 1987. During the Audit, petitioner discovered it employed certain individuals with respect to whom petitioner thought a tax credit (the WIN Credit) equal to a portion of the wages paid those employees during the year at issue might be available.

On July 10, 1985, petitioner engaged in Government Program Services, Inc. (GPSI) to assist petitioner in meeting the requirements for claiming the WIN Credit. Specifically, GPSI agreed to: (1) identify all employees of petitioner who might have satisfied the requirements of section 50B(h)(1)(A); and (2) acquire from appropriate state agencies certification indicating, with re-

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[1] All section references are to the Internal Revenue Code of 1954 as amended and in effect for the year at issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, unless otherwise indicated.

spect to those employees, certain prerequisites for claiming the WIN Credit were established.

Pursuant to its commitment under the contract, GPSI sought the necessary certification of petitioner's employees by making written requests to the appropriate agencies in the fourteen different states in which those employees were employed. GPSI's written requests were made on dates between July 22, 1985, and August 19, 1985, inclusive.

The certification provided by the state agencies took the form of letters, dated between August 26, 1985, and October 15, 1986, verifying that a total of 121 of petitioner's employees (WIN Employees) satisfied the requirements of section 50B(h)(1)(A). Specifically, these letters certified the WIN Employees either: (1) were eligible for financial assistance under Part A of Title IV of the Social Security Act (welfare assistance) and continually received welfare assistance during the 90 day period prior to the date petitioner hired the WIN employees; or (2) were placed in employment under a work incentive program established under section 432 (b)(1) of the Social Security Act. Although the WIN employees were hired by petitioner on various dates prior to January 29, 1982, petitioner did not seek certification for any of its WIN Employees until at least three and one-half years *after* the date they began working for petitioner.

During the Audit, petitioner provided respondent with the certification letters obtained by GPSI from the various state agencies. At the conclusion of the Audit in January 1987, respondent permitted petitioner a WIN Credit for the year at issue in the amount of $141,795.13.

On March 6, 1987, respondent issued the notice of deficiency upon which this case is based, determining adjustments to petitioner's income based on items unrelated to the WIN Credit. Petitioner timely filed a petition with this Court. Respondent for the first time raised the WIN

Credit issue in his Answer, alleging petitioner was *not* entitled to the $141,795.15 in tax credits previously allowed during the Audit.

Before trial the parties stipulated:

> 65. The only legal issues remaining for trial with respect to the WIN tax credit issue are the following:
>
> (a) whether the certification required to be obtained by Code § 50B(h)(1)(A) was required to be obtained prior to the dates the certifications were obtained by the Petitioner in the matter before the Court; and
>
> (b) whether "substantially full-time" as referred to in Code § 50B(h)(1)(B) means 20 hours per week, 30 hours per week, or something other than those two alternatives.

The opening and reply briefs filed by the parties addressed all issues presented for decision. With respect to the WIN Credit issue, the parties concentrated on their interpretation of the questions presented for decision as expressed in the above referenced stipulation. That is, the parties argued whether the requirements of sections 50B (h)(1)(A) and 50B(h)(1)(B) were met with respect to certain of petitioner's employees for the year at issue.

On December 27, 1988, the Court ordered the parties to address in supplemental briefs what impact, if any, the amendments to sections 50B and 51, made by the Economic Recovery Tax Act of 1981, Pub. Law 97-34, 95 Stat. 172 ("ERTA"), had on the WIN Credit issue. Supplemental briefs were filed by the parties as ordered.

OPINION

In its supplemental brief, petitioner first argues the Court is bound by the parties' stipulation and may consider only those issues stipulated by the parties. We disagree.

Rule 91(e) sets forth the binding effect of a stipulation. Generally, a stipulation of fact is a conclusive admission, controlling on the parties and enforced by the Court. Rule 91(e). However, this Court is not bound by a stipulation as to a question of law. *Swift & Co. v. Hocking Valley Ry. Co.*, 243 U.S. 281, 289 (1917); *Marquissee v. Commissioner* [Dec. 3767], 11 B.T.A. 334 (1928), affd. [2 USTC ¶ 671] 47 F.2d 32 (3d Cir. 1931). To be so bound could cause this Court to reach an absurd result unsupported by law. The parties stipulated the "only legal issues remaining for trial" were whether petitioner satisfied sections 50B(h)(1)(A) and 50B(h)(1)(B). This is a stipulation as to a question of law by which we are not bound. Accordingly, we will decide the applicability of section 51 with respect to the year at issue.

Alternatively, in the event we find our consideration is not bound by the parties' stipulation, petitioner argues its entitlement to the WIN Credit during the year at issue, with respect to most of petitioner's WIN Employees, was still controlled by section 50B despite the amendments made by ERTA to that section and section 51. Respondent argues the WIN Credit (sections 40, 50A, and 50B prior to amendment by ERTA) was merged into section 51's Targeted Jobs Credit by ERTA prior to the year at issue. Respondent asserts section 51 controls and petitioner does not qualify for either the WIN Credit or the Targeted Jobs Credit because petitioner has not satisfied the prerequisites for those credits found in section 51(d)(15) (now section 51(d)(16)).

Prior to ERTA, the WIN Credit was allowed by section 40 and determined under sections 50A and 50B. Under section 50A(a) as it appeared prior to ERTA, the amount of the WIN Credit allowed by section 40 was a specified percentage of first and second "work incentive program expenses" of the taxpayer. "Work incentive program expenses" were generally defined by pre-

ERTA section 50B(a)(1) as "the amount of wages paid or incurred by the taxpayer for services performed by eligible employees." The term "eligible employee" was defined by pre-ERTA section 50B(h)(1) as follows:

> (h) *Eligible Employee.*—
>
> (1) *Eligible employee.*—For purposes of this subpart the term "eligible employee" means an individual—
>
> (A) *who has been certified* by the Secretary of Labor or by the appropriate agency of State or local government as—
>
> (i) being eligible for financial assistance under part A of title IV of the Social Security Act and as having continually received such financial assistance during the 90-day period which immediately precedes the date on which such individual is hired by the employer, or
>
> (ii) having been placed in employment under a work incentive program established under section 432(b)(1) of the Social Security Act,
>
> (B) who has been employed by the taxpayer for a period in excess of 30 consecutive days on a substantially full-time basis (except as provided in subsection(i)),
>
> (C) who has not displaced any other individual from employment by the taxpayer, and
>
> (D) who is not a migrant worker.
>
> The term "eligible employee" includes an employee of the taxpayer whose services are not performed in connection with a trade or business of the taxpayer.
>
> (2) *Migrant worker.*—For purposes of paragraph (1), the term "migrant worker" means an individual who is employed for services for which the cus-

> tomary period of employment by one employer is less than 30 days if the nature of such services requires that such individual travel from place to place over a short period of time. [Emphasis added.]

Section 44B (currently section 38(b)(2)), however, allows a separate Targeted Jobs Credit determined under section 51. The amount of the Targeted Jobs Credit is a specified percentage of first and second year "qualified wages" paid by the taxpayer during the year. Sec. 51(a). Section 51(b)(1) defines "qualified wages" as "wages paid or incurred by the employer during the taxable year to individuals who are members of a targeted group." "Members of a targeted group" are listed in section 51(d)(1).

Sections 50A, 50B, and 51 were amended by ERTA in order to merge the WIN Credit into the Targeted Jobs Credit. First, ERTA effectively eradicated a separate WIN Credit by amending section 50B(a) to provide "The term 'work incentive program expenses' shall not include any amount paid or incurred in any taxable year beginning after December 31, 1981," Sec. 50B(a)(5). Further, to merge the WIN Credit into the Targeted Jobs Credit, ERTA amended section 51(d)(1) to include "an eligible work incentive employee" in the list of individuals who are "members of a targeted group." Sec. 51(d)(1)(H). Again, it is wages paid to a member of a targeted group that are eligible for the Targeted Jobs Credit. See sec. 51(d)(1). Thus, "eligible work incentive employees" became members of a "targeted group" effective for taxable years beginning after December 31, 1981. Section 261(g)(1)(B) of ERTA.

Eligible work incentive employees are defined in section 51(d)(9) as follows:

> (9) *Eligible work incentive employees*—The term "eligible work incentive employee" means an individual who *has been certified* by the designed local agency as—

(A) being eligible for financial assistance under part A of title IV of the Social Security Act and as having continually received such financial assistance during the 90-day period which immediately precedes the date on which such individual is hired by the employer, or

(B) having been placed in employment under a work incentive program established under section 432(b)(1) or 445 of the Social Security Act.

[Emphasis added.]

In addition to including eligible work incentive employees in the list of members of a targeted group, ERTA added a certification requirement to section 51 previously not required under either the WIN Credit or the Targeted Jobs Credit. Section 51(d)(15) [as noted, now section 51(d)(16)] in relevant part provides:

(15) *Special rules for certifications.*—

(A) *In general.*—An individual shall not be treated as a member of a targeted group unless, *on or before the day on which such individual begins work for the employer, the employer*—

(i) *has received a certification* from a designated local agency that such individual is a member of a targeted group, *or*

(ii) *has requested in writing such certification* from the designated local agency.

[Emphasis added]. Thus, pursuant to section 51(d)(15), an employer must receive or request in writing certification that an employee is a member of a targeted group *on or before the day* the employee begins work. This requirement will be referred to as the Section 51(d)(15) Certification Requirement.

Petitioner concedes the Targeted Jobs Credit applies with respect to wages paid *after* December 31, 1981, to

its WIN employees who began working *after* December 31, 1981. Petitioner also concedes those employees did not satisfy the Section 51(d)(15) Certification Requirement of the Targeted Jobs Credit.[2] Petitioner argues, however, this requirement does not apply with respect to wages paid its WIN Employees after December 31, 1981, who began employment *prior* to January 1, 1982.

Petitioner's argument is deduced as follows. The Section 51(d)(15) Certification Requirement only applies to "members of a targeted group" under section 51 (d)(1). The merger of the WIN Credit into the Targeted Jobs Credit was not effective until after December 31, 1981. Thus, petitioner reasons, "eligible work incentive employees" did not become members of a "targeted group" under section 51 until *after* that date. Petitioner asserts its WIN Employees were not "members of a targeted group" prior to January 1, 1982, and, accordingly, did not have to meet the Section 51(d)(15) Certification Requirement if hired before that effective date.

Respondent argues the Section 51(d)(15) Certification Requirement applies with respect to all wages paid to the WIN Employees after December 31, 1981, regardless of whether those employees began their employment before or after December 31, 1981. We agree with respondent.

The transitional rules under ERTA provide the Section 51(d)(15) Certification Requirement applies to "*all individuals* whether such individuals began work for their employer before, on, or after [August 13, 1981, the date of ERTA's enactment]." Section 261(g)(2)(A) of ERTA (emphasis added). Thus, by virtue of the transitional rules, petitioner's WIN Employees were deemed to be members of a "targeted group" *prior* to the effective

---

[2] The parties stipulated the employees at issue were all hired on dates prior to January 29, 1982. Thus, petitioner's concession applies only to employees hired after December 31, 1981, and before January 29, 1982.

date of the merger of the WIN Credit and the Targeted Jobs Credit. The transitional rules state, with respect to the addition of "eligible work incentive employees" to the list of members of a "targeted group," section 51(a) and (b) "shall be applied for taxable years beginning after December 31, 1981, as if such employees *had been* members of a targeted group for taxable years beginning *before* January 1, 1982." Sec. 261(g)(1)(B) of ERTA, (emphasis added).

For petitioner to have been entitled to the Targeted Jobs Credit for the year at issue, at a time when the WIN Credit was no longer available (after December 31, 1981), petitioner was required to obtain certification in accordance with section 51(d)(15) or meet the grace period for retroactive certifications under the transitional rules of section 1.51-1(d)(3), Income Tax Regs.[3] Petitioner did not satisfy either the Section 51(d)(15) Certification Requirements or the transitional rules. Accordingly, we hold petitioner is not entitled to the WIN Credit with respect to wages paid its otherwise eligible work incentive employees for the fiscal year at issue.

To reflect the foregoing,

Decision will be entered under Rule 155.

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[3] The transitional rules under section 1.51-1(d)(3), Income Tax Regs., granted relief to employers from strict application of the certification requirements found in section 51(d)(15) with respect to certain employees. Relief was granted by permitting employers to obtain, within a limited grace period, *retroactive certification* of employees beginning employment after June 28, 1981, and on or before September 26, 1981. The employer must either receive, or request in writing, a certification before September 26, 1981.

APPENDIX F

[Filed Feb. 2, 1995]

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

Nos. 91-70380, 91-70381

T.C. No. 10439-87

ALBERTSON'S, INC.,
Petitioner-Appellant-Cross-Appellee,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee-Cross-Appellant.

Before: CANBY and REINHARDT, Circuit Judges, and TASHIMA, District Judge.*

ORDER

The panel has voted to deny appellant's petition for rehearing and to reject the suggestion for rehearing en banc, filed January 13, 1994, and renewed December 20, 1994. The panel has also voted to deny appellant's petition for rehearing and to reject the suggestion for rehearing en banc filed December 19, 1994.

The full court was advised of the suggestions for rehearing en banc and no active judge has requested a vote on whether to rehear the matter en banc. Fed. R. App. P. 35.

The petitions for rehearing are denied and the suggestions for rehearing en banc are rejected.

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* The Honorable A. Wallace Tashima, United States District Judge for the Central District of California, sitting by designation.

APPENDIX G

Sections 38, 48, 163, and 404 of the Internal Revenue Code of 1954, 26 U.S.C. §§ 38, 48, 163, and 404 (1982); in pertinent part provide:

§ 38. Investment in certain depreciable property

(a) General rule.—There shall be allowed, as a credit against the tax imposed by this chapter, the amount determined under subpart B of this part.

(b) Regulations.—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section and subpart B.

§ 48. Definitions; special rules

(a) Section 38 property.—

(1) In general.—Except as provided in this subsection, the term "section 38 property" means—

(A) tangible personal property (other than an air conditioning or heating unit), or

(B) other tangible property (not including a building and its structural components) but only if such property—

(i) is used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services, or

(ii) constitutes a research facility used in connection with any of the activities referred to in clause (i), or

(iii) constitutes a facility used in connection with any of the activities referred to in clause (i) for the bulk storage of

fungible commodities (including commodities in a liquid or gaseous state), or

(C) elevators and escalators, but only if—

(i) the construction, reconstruction, or erection of the elevator or escalator is completed by the taxpayer after June 30, 1963, or

(ii) the elevator or escalator is acquired after June 30, 1963, and the original use of such elevator or escalator commences with the taxpayer and commences after such date, or

(D) single purpose agricultural or horticultural structures; or

(E) in the case of a qualified rehabilitated building, that portion of the basis which is attributable to qualified rehabilitation expenditures (within the meaning of subsection (g)), or

(F) in the case of qualified timber property (within the meaning of section 194(c)(1)), that portion of the basis of such property constituting the amortizable basis acquired during the taxable year (other than that portion of such amortizable basis attributable to property which otherwise qualifies as section 38 property) and taken into account under section 194 (after the application of section 194(b)(1)), or

(G) a storage facility used in connection with the distribution of petroleum or any primary product of petroleum.

Such term includes only recovery property (within the meaning of section 168 without regard to any useful life) and any other property with respect to

which depreciation (or amortization in lieu of depreciation) is allowable and having a useful life (determined as of the time such property is placed in service) of 3 years or more. The preceding sentence shall not apply to property described in subparagraph (F) and, for purposes of this subpart, the useful life of such property shall be treated as its normal growing period.

§ 163. Interest

(a) General rule.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

§ 404. Deduction for contributions of an employer to an employees' trust or annuity plan and compensation under a deferred-payment plan

(a)—General rule.—If contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan, or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under section 162 (relating to trade or business expenses) or section 212 (relating to expenses for the production of income); but, if they satisfy the conditions of either of such sections, they shall be deductible under this section, subject, however, to the following limitations as to the amounts deductible in any year:

* * * *

(5) Other plans.—If the plan is not one included in paragraph (1), (2), or (3), in the taxable year in which an amount attributable to the contribution is includible in the gross income of employees participating in the plan, but, in the case of a plan in which more than one employee participates only if separate accounts are maintained for each employee.

* * * *

(d) Deductibility of payments of deferred compensation, etc., to independent contractors.—If a plan would be described in so much of subsection (a) as precedes paragraph (1) thereof (as modified by subsection (b)) but for the fact that there is no employer-employee relationship, the contributions or compensation—

(1) shall not be deductible by the payor thereof under section 162 or 212, but

(2) shall (if they would be deductible under section 162 or 212 but for paragraph (1)) be deductible under this subsection for the taxable year in which an amount attributable to the contribution or compensation is includible in the gross income of the persons participating in the plan.

Section 404 of the Internal Revenue Code of 1986, 26 U.S.C. § 404 (1994), in pertinent part provides:

§ 404. Deduction for contributions of an employer to an employees' trust or annuity plan and compensation under a deferred-payment plan

(a) General rule.—If contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan, or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under this chapter, but, if they would otherwise be deductible, they shall be deductible under this section, subject, however, to the following limitations as to the amounts deductible in any year:

* * * *

(5) Other plans.—If the plan is not one included in paragraph (1), (2), or (3), in the taxable year in which an amount attributable to the contribution is includible in the gross income of employees participating in the plan, but, in the case of a plan in which more than one employee participates only if

separate accounts are maintained for each employee. For purposes of this section, any vacation pay which is treated as deferred compensation shall be deductible for the taxable year of the employer in which paid to the employee.

* * * *

(d) Deductibility of payments of deferred compensation, etc., to independent contractors.—If a plan would be described in so much of subsection (a) as precedes paragraph (1) thereof (as modified by subsection (b)) but for the fact that there is no employer-employee relationship, the contributions or compensation—

(1) shall not be deductible by the payor thereof under this chapter, but

(2) shall (if they would be deductible under this chapter but for paragraph (1)) be deductible under this subsection for the taxable year in which an amount attributable to the contribution or compensation is includible in the gross income of the persons participating in the plan.

Treas. Reg. § 1.48-1(e), 26 C.F.R. § 48-1(e) (1982), provides as follows:

(e) *Definition of building and structural components.* —(1) Generally, buildings and structural components thereof do not qualify as section 38 property. The term "building" generally means any structure or edifice enclosing a space within its walls, and usually covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, parking, display, or sales space. The term includes, for example, structures such as apartment houses, factory and office buildings, warehouses, barns, garages, railway or bus stations, and stores. Such term includes any such structure constructed by, or for, a lessee even if such structure must be removed, or ownership of such structure reverts to the lessor, at the termination of the lease. Such term

does not include (i) a structure which is essentially an item of machinery or equipment, or (ii) a structure which houses property used as an integral part of an activity specified in section 48(a)(1)(B)(i) if the use of the structure is so closely related to the use of such property that the structure clearly can be expected to be replaced when the property it initially houses is replaced. Factors which indicate that a structure is closely related to the use of the property it houses include the fact that the structure is specifically designed to provide for the stress and other demands of such property and the fact that the structure could not be economically used for other purposes. Thus, the term "building" does not include such structures as oil and gas storage tanks, grain storage bins, silos, fractionating towers, blast furnances, basic oxygen furnaces, coke ovens, brick kilns, and coal tipples.

(2) The term "structural components" includes such parts of a building as walls, partitions, floors, and ceilings, as well as any permanent coverings therefor such as paneling or tiling; windows and doors; all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts; plumbing and plumbing fixtures, such as sinks and bathtubs; electric wiring and lighting fixtures; chimneys; stairs, escalators, and elevators, including all components thereof; sprinkler systems; fire escapes; and other components relating to the operation or maintenance of a building. Howeevr, the term "structural components" does not include machinery the sole justification for the installation of which is the fact that such machinery is required to meet temperature or humidity requirements which are essential for the operation of other machinery or the processing of materials or foodstuffs. Machinery may meet the "sole justification" test provided by the preceding sentence even though it incidentally provides for the comfort of employees, or serves, to an insubstantial degree, areas where such temperature or humidity requirements are not essential. For

example, an air conditioning and humidification system installed in a textile plant in order to maintain the temperature or humidity within a narrow optimum range which is critical in processing particular types of yarn or cloth is not included within the term "structural components". For special rules with respect to an elevator or escalator, the construction, reconstruction, or erection of which is completed by the taxpayer after June 30, 1963, or which is acquired after June 30, 1963, and the original use of which commences with the taxpayer and commences after such date, see section 48(a)(1)(C) and paragraph (m) of this section.

* * * *

APPENDIX H

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

Nos. 91-70380, 91-70381

ALBERTSON'S, INC.,
Appellant-Cross-Appellee

v.

COMMISSIONER OF INTERNAL REVENUE,
Appellee-Cross-Appellant

On Appeals from the Decision of
the United States Tax Court

APPELLEE-CROSS-APPELLANT'S PETITION
FOR REHEARING WITH SUGGESTION
FOR REHEARING *EN BANC*

Pursuant to Rules 35 and 40 of the Federal Rules of Appellate Procedure, and Rules 35-1 and 40-2 of the Rules of this Court, the Commissioner of Internal Revenue, appellee-cross-appellant herein, through her counsel, hereby petitions for a rehearing in this case on the deferred compensation issue, described below, and respectfully suggests that the rehearing be *en banc*. The decision of the panel does not conflict with any prior de-

cision of this Court, and is not in conflict with the decision of any other circuit. But as is explained in greater detail below, the issue as to which rehearing is sought by the Commissioner is one of exceptional importance to the administration of the federal income tax laws. We have been advised that the Treasury Department's Office of Tax Policy estimates that if the panel's decision were to be applied nationwide, the reduction in federal tax receipts could total $7 billion from Fiscal Year 1994 through Fiscal Year 1999. The Office of Tax Policy has also estimated that even if the decision were limited in application to taxpayers able to establish venue in this Circuit, the loss in tax revenue would be approximately $2 billion over that five-year period.

* * * *

As we indicated above, the Department of Treasury, Office of the Assistant Secretary for Tax Policy, has directed its staff (which provides revenue gain and loss estimates in connection with proposed tax legislation) to prepare an estimate of the revenue effect of the panel's decision. Their analysis considers the revenue impact on past years that are still open for purposes of filing refund claims, and for the next five taxable years. The staff, we are advised, considered existing statistical information, such as the fact that more than 60% of Fortune 500 corporations utilize nonqualified deferred compensation plans. The use of such plans is not limited to major corporations, however, as any company, whether large or small, may easily draft the sort of deferred compensation plan employed by taxpayer here.

Based on its analysis, the Department of Treasury advises us that the expected revenue loss, in this Circuit alone, resulting from the panel's opinion could be as much as approximately $2 billion. If applied nationally, the loss of tax receipts could be approximately $7 bil-

lion.[6] By any measure, this is a case of major fiscal importance.[7]

The panel's opinion has generated a substantial amount of comment and discussion concerning the unprecedented new deduction that it has approved. See Lee Sheppard, *The Ninth Circuit Creates a New Interest Deduction*, 62 Tax Notes 405, 406 (January 24, 1994); William Raby, *When is Interest 'Compensation'?*, 62 Tax Notes 477, 478 (January 24, 1994). As an issue of exceptional importance to the administration of the tax law that has sharply divided the Tax Court judges who have considered it, it is appropriate for *en banc* review.

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[6] We are aware of the fact that the Bureau of National Affairs Daily Tax Report for February 7, 1994, attributes to an IRS official an estimate of the potential revenue loss of $1 billion. Soon after the panel's opinion, the Department of the Treasury made a preliminary estimate that the revenue loss resulting from the decision could be as much as $1 billion. We so represented to the Court in our motion for extension of time to file this petition, and the estimate thereby became a matter of public record. The Department of Treasury has since conducted a more comprehensive analysis and determined that the estimated revenue loss in the Ninth Circuit and nationally is in the larger amounts set forth in this petition.

[7] The panel's decision treating the additional amounts as interest also raises significant questions concerning whether the participants have constructively received taxable interest income.

CONCLUSION

For these reasons, this petition for rehearing should be granted, and it is sugested that rehearing be held *en banc*. On rehearing, this Court should rule that taxpayer is not entitled to current interest deductions in connection with its deferred compensation plan.

Respectfully submitted,

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February 11, 1994

Supreme Court, U.S.
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No. 94-1796

In the Supreme Court of the United States

OCTOBER TERM, 1995

ALBERTSON'S, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether petitioner is entitled to current deductions for annual increases, which it characterizes as "interest," in its obligations to make future payments to selected executives under deferred compensation agreements that do not otherwise qualify for immediate deductions under the Internal Revenue Code, even though the executives concerned report no income under those agreements until the years in which payments are actually received.

2. Whether the "sole justification" for petitioner's installation of heating, ventilating, and air conditioning systems in its retail grocery stores was to provide the temperature and humidity necessary to operate refrigerated food cases, so that the cost of those systems qualified for the tax credit formerly available for investments in certain personal property.

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In the Supreme Court of the United States

OCTOBER TERM, 1995

No. 94-1796

ALBERTSON'S, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The initial opinion of the court of appeals (Pet. App. 20a-40a) is reported at 38 F.3d 1046. That court's opinion on rehearing of the deferred compensation issue (Pet. App. 1a-19a) is reported at 42 F.3d 537. The opinion of the United States Tax Court on the deferred compensation issue (Pet. App. 41a-69a) is reported at 95 T.C. 415. That court's memorandum opinion on the investment tax credit issue (Pet. App.

70a-81a) is reported unofficially at 56 T.C. Memo. (CCH) 928.[1]

JURISDICTION

The judgment of the court of appeals was originally entered on December 30, 1993. That court's judgment on rehearing of the deferred compensation issue was entered on December 5, 1994. Further petitions for rehearing were denied on February 2, 1995. Pet. App. 92a. The petition for a writ of certiorari was filed on May 1, 1995. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

This case involves deficiencies in petitioner's federal income taxes for petitioner's taxable year ending February 3, 1983. During that year petitioner operated more than 400 retail food and drug stores throughout the western, southern, and southeastern United States. See Pet. App. 21a n.1.

1. a. Beginning no later than 1974, petitioner entered into "deferred compensation" agreements with eight of its senior executives and one outside director. Pet. App. 2a, 27a. Under the agreements, the employees elected to defer payment and receipt of part of their yearly salary, bonuses, or director's fees until they retired or otherwise terminated their employment with petitioner (and thereafter, at each participant's option, for up to fifteen additional years). *Id.* at 2a-3a. At the end of the deferral period the

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[1] The court of appeals also affirmed (Pet. App. 22a-26a) the Tax Court's decision that petitioner was not entitled to certain work incentive credits. That decision (*id.* at 82a-91a) is reported informally at 59 T.C. Memo. (CCH) 186. Petitioner does not seek review of the work incentive credit issue.

participants were entitled to receive the amounts originally deferred, in a lump sum or periodically, plus "a further sum of money equal to the amount of interest accrued which shall be calculated by applying a rate of interest to the total accumulated amount of deferred compensation including accrued interest." *Id.* at 3a n.1, 27a n.9. The "rate of interest" used was either petitioner's average long term borrowing rate for the appropriate year, or a published rate for certificates of deposit over $1 million. *Id.* at 2a-3a & n.1, 27a & n.9; Stip. of Facts, Exhs. 4-D through 12-L.

Petitioner did not fund (through present contributions to a trust, escrow account, or similar arrangement) any portion of its contractual obligation to make future payments under the deferred compensation agreements. The obligation was an unsecured promise, reflected only in bookkeeping entries. Pet. App. 42a-43a. Since 1960, the Internal Revenue Service has permitted employees who enter into such agreements before rendering services, and who otherwise compute their income and tax liability on the basis of cash receipts and disbursements, to defer recognition of any income until the years that payments under the agreement are actually received. Rev. Rul. 60-31, 1960-1 C.B. 174, modified by Rev. Rul. 70-435, 1970-2 C.B. 100.

Petitioner is an accrual-basis taxpayer (Pet. App. 21a n.1). Before 1983, petitioner claimed no deductions, either for amounts that participants elected to defer or for any "further sum[s] of money" to be paid eventually under the agreements, unless payments were actually made to a participant during the year. Pet. App. 45a. For the taxable year at issue, however, petitioner contended for the first time that the "further sum[s] of money" accrued on its books, but

not paid out, under the agreements constituted "interest * * * on indebtedness" that was currently deductible under Section 163 of the Internal Revenue Code, 26 U.S.C. 163 (1988 & Supp. V 1993). Pet. App. 45a. The Commissioner of Internal Revenue disallowed the deduction, *id.* at 46a, and petitioner sought review of that determination in the United States Tax Court.[2]

b. The full Tax Court upheld the Commissioner's position. Pet. App. 41a-60a. The nine-judge majority concluded that the amounts petitioner sought to deduct were not "interest" on "indebtedness" for purposes of Section 163. Pet. App. 48a-53a. Because participants entered into deferred compensation

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[2] In 1982, petitioner requested permission "to change its method of accounting for interest accrued on deferred compensation from the cash basis to the accrual basis." Stip. of Facts, Exh. 18-R, App. A; see Pet. 4. The IRS's letter granting that permission, which focused largely on the accounting mechanics of the change, made clear that "[t]he taxpayer['s] belie[f]" that the amounts in question "should be characterized as interest" was "a material representation upon which [the] letter [was] issued." Stip. of Facts, Exh. 20-T, at 1. The letter granted permission to deduct any interest expense "as it [was] properly incurred" (*id.* at 2), and explicitly stated that the letter "should not be construed as a determination as to the proper timing for the accrual of interest expense on deferred compensation or to its characterization as a liability to the taxpayer" (*id.* at 3). The IRS later issued a technical advice memorandum which concluded that the amounts petitioner had designated as "interest" were instead "compensation for personal services rendered" and, accordingly, revoked its approval of the change in accounting method. Stip. of Facts ¶ 41. Petitioner expressly abandoned below any argument that the Commissioner's decision to revoke the prior permission and to disallow the deductions at issue here was impermissibly "retroactive." Pet. App. 46a-47a.

agreements before performing the services for which the compensation was rendered. they never had a legal right to demand payment of that compensation in the year they rendered the services. Because they did not receive payment, either actually or constructively, they were not required to report the compensation as income for that year. Correspondingly, however, "[p]etitioner could not have 'borrowed' something from the * * * participants that the * * * participants never had the right to possess." *Id.* at 50a. Thus, additional amounts computed and eventually to be paid under the terms of the agreements were not "interest" on "indebtedness," but rather "an integral part of the method used by petitioner to calculate the total amount of deferred compensation to be paid" under those agreements. *Id.* at 53a.

Four concurring judges agreed that petitioner was not entitled to a current deduction, but preferred not to rest their analysis on whether the additional amounts at issue represented "interest" on money constructively "borrowed" from employees who entered into deferred compensation agreements. Pet. App. 61a-63a. The concurrence focused instead on Section 404 of the Code, "the plain purpose of [which] is to require matching of income inclusion and deduction as between the employee and employer" in such arrangements. Pet. App. 62a. The opinion concluded that, even if the time-value component of a deferred compensation payment were to be labelled as "interest," "allow[ing] an accrual method employer to deduct interest in advance of inclusion by employees

would frustrate the matching principle apparent in the statute." *Id.* at 63a.[3]

Five judges dissented, concluding that the amounts at issue were deductible as interest under Section 163, without limitation by Section 404. Pet. App. 64a-69a.

c. The court of appeals at first "reluctantly" reversed. Pet. App. 27a-37a; *id.* at 29a. The court concluded that the "additional amounts" specified in the deferred compensation agreements represented a fair measure of the time value of money, and therefore qualified as "interest" for purposes of Section 163 of the Code. Pet. App. 29a-32a. Although sympathetic to the argument that Congress intended the timing restrictions of Section 404 to apply to all payments under a deferred compensation plan (Pet. App. 37a; see also *id.* at 4a-5a), the court concluded (*id.* at 32a-37a) that the language of Section 404 did not prohibit the current deduction of accrued amounts that were properly characterized as "interest" for purposes of Section 163.

The same panel of the court of appeals subsequently granted the government's petition for rehearing, vacated its earlier opinion, and affirmed the Tax Court's decision. Pet. App. 1a-19a. On rehearing, the court declined to reach the question whether the additional amounts payable under petitioner's deferred compensation agreements should be characterized as "interest." See *id.* at 4a-5a, 19a. Instead, the court focused on Section 404's principle of "ensur[ing] matching of income inclusion and

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[3] Judge Hamblen indicated agreement with both the majority and concurring opinions. Pet. App. 60a, 63a. Judge Whalen did not participate in the decision. *Id.* at 60a.

deduction between employee and employer" under deferred compensation schemes like petitioner's. Pet. App. 11a; see *id.* at 11a-18a. The court concluded that "[w]hether or not the additional amounts constituted interest" (*id.* at 19a), allowing the deductions sought by petitioner would "contravene the clear purpose of the taxation scheme Congress created to govern deferred compensation plans" (*id.* at 8a). In particular, it would undercut the statutory incentives that Congress created to encourage employers to create "qualified" deferred compensation plans (which must generally be broadly available to the sponsor's employees, pre-funded, and administered through a special trust), by providing similar or even greater incentives to create "nonqualified" arrangements like petitioner's deferred compensation agreements with a few of its highly compensated executives. See *id.* at 8a-10a, 12a-15a. The court therefore rejected petitioner's argument that Section 404 authorized deduction of the additional amounts before they were actually paid out under the agreements in question. Pet. App. 19a.

2. On audit of its return for the 1982-1983 tax year, petitioner claimed the investment tax credit (ITC), formerly available under Section 38 of the Code (see Pet. App. 93a-95a), with respect to heating, ventilating, and air conditioning (HVAC) systems that it had installed in 33 of its stores. See Pet. App. 38a, 76a. Under the applicable Treasury Department regulation, HVAC systems were generally considered "structural components" of the buildings in which they were installed, and therefore did not qualify for the ITC. Treas. Reg. § 1.48-1(e) (1982) (*reprinted at* Pet. App. 97a-99a). Under the same regulation, however, HVAC systems could qualify for the ITC

under an exception applicable to "machinery the sole justification for the installation of which" was that it was "required to meet temperature or humidity requirements which [were] essential for the operation of other machinery." Treas. Reg. § 1.48-1(e)(2) (1982) (Pet. App. 98a).

Petitioner claimed that it was entitled to the ITC because its "sole justification" for installing the HVAC systems was meeting the temperature and humidity requirements for its refrigerated food display cases and computerized checkout equipment. Pet. App. 38a. The Commissioner disallowed the claimed credits, and petitioner sought review in the Tax Court.

The Tax Court found that the HVAC systems in petitioner's stores maintained the temperature and humidity conditions appropriate for the proper functioning of open-front refrigerated food display cases. Pet. App. 81a; see *id.* at 71a-74a. Finding the existence of an HVAC system "crucial" to the operation of petitioner's stores, and any benefits related to customer comfort merely "incidental," the court concluded that those systems met the "sole justification" test of the regulations. *Id.* at 81a.

The court of appeals reversed. Pet. App. 37a-40a. The court pointed out that petitioner's HVAC systems "play[ed] an important role in ventilating its supermarkets," thus keeping them clean, pleasant, and safe. *Id.* at 38a-39a. Moreover, in the court's view, air conditioning and heating "clearly provide[d] a comfortable shopping environment for [petitioner's] customers" in stores located from Florida to Idaho. *Id.* at 39a. Indeed, the court noted that petitioner "had already installed HVAC systems in most of its supermarkets [during the 1950s], well before it was

aware of any interrelationship between HVAC systems and the proper functioning of its other equipment." *Ibid.* Under those circumstances, the court concluded that the Tax Court had committed "clear error" in finding that petitioner's HVAC systems satisfied the "sole justification" test. *Id.* at 39a-40a.

ARGUMENT

1. Petitioner contends (Pet. 12-13, 15-23) that the court of appeals erred in rejecting petitioner's attempt to take current deductions for deferred compensation payments that will not be made, or included in its employees' income, for years to come. The court's decision is correct, and the matter does not warrant further review.

a. Before 1942, employers using the accrual basis of accounting could generally accrue deferred compensation and deduct it, as an "ordinary and necessary business expense," in the year in which the obligation to make a particular payment first arose. See Pet. App. 55a. Most employees, by contrast, compute income on the basis of cash receipts and disbursements. Thus, by entering into a properly structured deferred compensation agreement with an employee, an accrual-basis employer could receive immediate deductions without any current cash outlay, while the employee could receive a vested right to future payments without reporting any current income. See *id.* at 10a. This asymmetry in tax accounting led to "considerable abuse." *Id.* at 55a-56a.

To address this situation, Congress amended what is now Section 404 of the Internal Revenue Code. Under Section 404 (and related provisions), employers

and employees may achieve the dual advantages of current deductibility and deferred inclusion only by maintaining a so-called "qualified" deferred compensation plan. Among other requirements, such a plan must not discriminate in favor of highly compensated individuals; the employer must generally make contributions in trust for the sole benefit of plan participants (thus placing the funds beyond the control of the employer in the year of contribution and deduction); and the employer's contributions must generally meet certain minimum standards in relation to the benefits promised under the plan. If a plan meets all the requirements for "qualification," then the employer receives a current deduction for amounts contributed to the trust, the trust itself is exempt from tax, and employee participants are not taxed, either on the employer's contributions or on the trust's earnings, until they actually receive benefits paid by the trust under the plan. See generally 26 U.S.C. 401(a), 402(a), 404, and 501(a) (1988 & Supp. V 1993); 2 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 60.1, at 60-2 (2d ed. 1990) (hereafter Bittker & Lokken).

An employer may enter into a deferred compensation agreement with any of its employees without complying with the nondiscrimination, trust, funding, or other conditions necessary to create a "qualified" plan. Since 1942, the Code has provided that when an employer incurs an obligation for future payment under such a "nonqualified" arrangement, it is not entitled to a deduction until the year in which an equivalent amount is includible in the income of the employee concerned. See Pet. App. 10a-11a, 56a; 26 U.S.C. 404(a)(5) and (b). The year of inclusion for a cash-basis employee is determined under principles of

actual or "constructive" receipt. Under longstanding practice, if an employee agrees in advance to defer compensation for services to be rendered in the future, the employee generally will not be treated as having constructively received the compensation so deferred until payment is actually made. See, *e.g.*, Rev. Rul. 60-31, 1960-1 C.B. 174, modified by Rev. Rul. 70-435, 1970-2 C.B. 100; *Martin* v. *Commissioner*, 96 T.C. 814 (1991); *Commissioner* v. *Oates*, 207 F.2d 711 (7th Cir. 1953); Bittker & Lokken ¶ 60.2.1, at 60-4.

b. As the Tax Court correctly recognized (Pet. App. 48a-53a), against this background, the "further sum[s] of money" provided for in petitioner's deferred compensation agreements (see *id.* at 3a n.1) are not properly viewed as "interest * * * on indebtedness" that is deductible under Section 163(a) of the Code. We do not dispute that those amounts are intended to reflect the time value of money. See Pet. App. 30a-31a. While all interest reflects time value, however, not all reflections of time value are "interest" for purposes of Section 163.[4]

The essential relationship between an employer and an employee with whom it enters into a deferred compensation agreement remains that of employer and employee; it does not become that of borrower and lender. All amounts that the employee agrees to receive in the future—in exchange for services to be

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[4] See, *e.g.*, *Garvey, Inc.* v. *United States*, 726 F.2d 1569, 1574 (Fed. Cir.) (purchase of property in exchange for private annuity was a capital expenditure, and time-value component of annuity was not deductible "interest"), cert. denied, 469 U.S. 823 (1984); *Autenreith* v. *Commissioner*, 115 F.2d 856, 858 (3d Cir. 1940); *Estate of Arbury* v. *Commissioner*, 93 T.C. 136, 141 (1989); see also *Bell* v. *Commissioner*, 76 T.C. 232, 237 (1981).

rendered after the date of the agreement—are therefore properly and accurately characterized as compensation for those services, no matter when paid or how denominated in the agreement. Moreover, while the additional amounts under petitioner's agreements were computed on the basis of stated interest rates, similar agreements may reflect "time value" through adjustments based on, for example, the consumer price index, an index of stock or bond market returns, returns on the employer's own stock, or returns on the actual investment of the deferred payments. See Bittker & Lokken ¶ 60.2.1, at 60-11. Petitioner's theory would presumably require that all such amounts be treated as "interest" for purposes of Section 163. That result is not an obvious interpretation of the statutory language. Compare Pet. 15-16.

Nor is it obvious on what "indebtedness" petitioner would be paying "interest," under its theory, for purposes of Section 163(a). Certainly this case does not involve any borrowing by petitioner, or any loan by its employees, in the ordinary sense of those terms. Cf. *Old Colony R.R.* v. *Commissioner*, 284 U.S. 552, 561 (1932) ("We cannot believe that Congress used the word ['interest'] having in mind any concept other than the usual, ordinary and everyday meaning of the term."). In its first opinion, the court of appeals treated petitioner's contractual obligation to make payments under the deferred compensation agreements as, in itself, "indebtedness" for these purposes. Pet. App. 32a. The court reached that conclusion, however, by applying a general

definition taken out of context.[5] And while "an indebtedness is an obligation, an obligation is not necessarily an 'indebtedness' within the meaning of" Section 163(a). *Deputy* v. *du Pont*, 308 U.S. 488, 497 (1940).

The Code does treat some contractual obligations as including an implicit time-value component that must be given separate effect for tax purposes. And, as some of the opinions below point out (see Pet. App. 30a n.14, 61a, 65a n.4), Congress has in recent years required taxpayers to identify and account for such "hidden" or "implicit" interest in a variety of situations. Even in cases (unlike this one) involving transactions that clearly involve "indebtedness," however, it has generally done so by enacting specific and often

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[5] The court cited (Pet. App. 32a) the statement in *Horn* v. *Commissioner*, 90 T.C. 908, 938 (1988), that "[i]ndebtedness has been defined as 'an unconditional legally enforceable obligation for the payment of money.'" *Horn*, in turn, was quoting *Autenreith* v. *Commissioner*, 115 F.2d 856, 858 (3d Cir. 1940), and cited *Knetsch* v. *United States*, 364 U.S. 361 (1960). *Horn* rejected the validity, for tax purposes, of sham "promissory notes" signed by investors in an abusive tax shelter scheme. See 90 T.C. at 938-940. *Autenreith* refused to recognize as "indebtedness" for purposes of Section 163 the obligation (unconditional and presumably enforceable) of three sons to make annual "interest" payments to their mother, on the ground that the payments were actually principal payments for partnership interests acquired from their father after his death. See 115 F.2d at 858. *Autenreith* relied on *Commissioner* v. *Park*, 113 F.2d 352 (3d Cir. 1940), which held, unremarkably, that an interest-bearing demand note was "indebtedness" within "the ordinary meaning of the word." And *Knetsch* refused to recognize, for tax purposes, the "interest" paid on "loans" that were part of a structured tax-shelter transaction. See 364 U.S. at 364-366. None of those decisions has much to do with the situation at issue in this case.

technically complex provisions. See, *e.g.*, 26 U.S.C. 467 (leases with deferred payment provisions), 483 (certain amounts under deferred-payment sales contracts are to be "treated as interest"), 1271-1275 (1988 & Supp. V 1993) ("original issue discount" on debt instruments, including those issued in consideration for the sale or exchange of property), 7872 (loans with below-market interest rates); see also 26 U.S.C. 163(e) (1988 & Supp V 1993) (coordinating interest deduction and original issue discount rules). In the absence of such a provision applicable to deferred compensation agreements, there is no reason to stretch the normal meaning of the statutory terms "interest" and "indebtedness" to include any part of the compensation promised under petitioner's agreements. See, *e.g.*, *Deputy* v. *du Pont*, 308 U.S. at 493 (deductions are to be allowed only as clearly provided by law).[6]

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[6] If petitioner was concerned with the deductibility of any "time value" component of its deferred payments, it could have structured its affairs differently to ensure that result. Had petitioner paid compensation to its executives and then borrowed it back (see, *e.g.*, Pet. 15), or paid its employees with a non-forfeitable promissory note with terms similar to those of the deferred compensation agreements, then its interest deductions would not be in doubt. Of course, either of those arrangements would presumably have required the employees to recognize current income, which would have made the arrangement less attractive to them. See Treas. Reg. § 1.61-2(d)(4); see also Pet. App. 51a n.7. Petitioner used deferred compensation agreements in order to avoid current taxation of its employees. Having selected a particular form for its transaction, petitioner is bound by that form's collateral tax consequences, *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 148-149 (1974), which in this case include an equivalent deferral of its own deductions. As

We do not contend that the amounts in question in this case could not be viewed as "interest" on "indebtedness" under any circumstances or for any purpose. The question in this case is only whether such a characterization is appropriate for purposes of the deduction provided by Section 163 of the Code. Compare *NationsBank of North Carolina, N.A.* v. *Variable Annuity Life Ins. Co.*, 115 S. Ct. 810, 816 (1995); cf. *Clayton* v. *United States*, No. 92-712T (Ct. Fed. Cl. June 30, 1995) (payments from qualified trust are not "compensation" for purposes of certain source-of-income rules applicable to non-U.S. taxpayers) (*reprinted in* 1995 Daily Tax Rptr. (BNA) No. 131, at K11, K22-K23 (July 10, 1995)). Having considered the matter in light of the purposes of that Section and the nature of petitioner's deferred compensation agree-ments, the Commissioner of Internal Revenue has concluded (as did a majority of the Tax Court, Pet. App. 47a-59a) that all payments under those agreements should be treated as "compensation" for purposes of Section 404, and that no part should be treated as "interest" for purposes of Section 163. That contextual interpretation is plainly reasonable, and it is entitled to deference from the courts. See, *e.g.*, *NationsBank of North Carolina*, 115 S. Ct. at 816; *Good Samaritan Hosp.* v. *Shalala*, 113 S. Ct. 2151, 2161-2162 (1993).

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petitioner acknowledges (Pet. 4), for several years it adopted exactly that approach to its obligations under the agreements in question. In that light, petitioner's contention that the decision below "disappointed many taxpayers' settled expectations" (Pet. 20) would appear not to apply, in any event, to petitioner itself.

c. Both courts below also recognized (Pet. App. 7a-19a, 53a-63a) that, whether or not the "further sum[s]" computed under petitioner's deferred compensation agreements could be viewed as "interest" for purposes of Section 163, the recognition of immediate deductions as those amounts accrued would be inconsistent with the terms and purpose of Section 404 of the Code.

Petitioner's deferred compensation agreements constituted a nonqualified, unfunded deferred compensation plan benefitting only eight high-ranking executives and one outside director. As discussed above (see pp. 11-12, *supra*), the nature of the relationship between an employer and an employee is one of payment for services performed, whether that payment is made currently, or deferred under an express agreement entered into before the relevant services are performed. Whether the amount to be paid is adjusted for the delay by using an interest rate, returns on the employer's stock, a cost-of-living factor, a stock or bond index, or some other factor, the employee has not in fact invested in the employer's stock or bonds, or in some informal investment fund. The essence of the relationship remains future compensation for past services, and all amounts payable under the agreement are therefore "compensation" for purposes of Section 404. And Section 404(a)(5) prohibits deductions for any such "compensation" under a non-qualified plan until the amount is actually paid to the participant and includible in his income.

Section 404 has its origins in Section 162(b) of the Revenue Act of 1942, ch. 619, 56 Stat. 863 (codified at 26 U.S.C. 23(p) (1946)). See Pet. App. 10a. In enacting Section 23(p), Congress expressed its intention that

an employer's deductions be matched in time with a participant's receipt of income:

> If an employer on the accrual basis defers paying any compensation to the employee until a later year or years under an arrangement having the effect of a stock bonus, pension, profit-sharing, or annuity plan, or similar plan deferring the receipt of compensation, he *will not be allowed a deduction* until the year in which the compensation is paid.

H.R. Rep. No. 2333, 77th Cong., 2d Sess. 106 (1942) (emphasis added); S. Rep. No. 1631, 77th Cong., 2d Sess. 141 (1942). As the court of appeals recognized (Pet. App. 11a-12a), that "matching" principle has been widely acknowledged as "the key to section 404." See, *e.g.*, Bittker & Lokken ¶ 60.1, at 60-2 ("The most consistent feature of the rules for nonqualified plans is that the employer is ordinarily allowed no deduction for contributions, payments, or benefits until they are taxed to the employee.").

Petitioner argues (Pet. 18-19) that because the version of Section 404(a) in effect in the year in question (see Pet. App. 95a) explicitly prohibited only deductions under Sections 162 (relating to business expenses) or 212 (relating to other investment expenses), Congress could not have intended to bar deductions for interest expenses under Section 163. As noted above, however, before Section 404's precursor was enacted in 1942, accrual-basis employers deducted deferred compensation, in advance of actual payment, "as an ordinary and necessary business expense." Pet. App. 55a. There is no indication that Congress at the time thought of such payments, either when accrued or when actually made, as

including any time-value component that could be separated out analytically and treated as "interest" for purposes of tax deductibility. Compare *Old Colony R.R.* v. *Commissioner*, 284 U.S. at 560-561 ("[W]e think that in the common understanding 'interest' means what is usually called interest by those who pay and those who receive the amount so denominated in bond and coupon, and that the words of the statute permit the deduction of that sum, and do not refer to some esoteric concept derived from subtle and theoretic analysis."). Because Congress had no reason to believe that an employer's obligation to make deferred compensation payments might be deductible under any Code provision other than Section 162 or 212, it is not surprising that Section 404 at first explicitly addressed only deductions under those two provisions.

In 1986—at a time when it had become thoroughly familiar with the concept of implicit interest in the tax context—Congress amended Section 404 to replace the specific references to Sections 162 and 212 with a general reference to deductions "under this chapter" (that is, Code Sections 1-1399). See Pet. App. 96a. The change was made retroactive to 1984, and treated as a technical and clarifying amendment:

> The bill clarifies that the deduction-timing rules for deferred compensation arrangements apply to any plan or method of deferring compensation *regardless of the section under which the amounts might otherwise be deductible* and that the amounts shall be deductible under section 404(a)(5) and *shall not otherwise be deductible under any other section.*

S. Rep. No. 313, 99th Cong., 2d Sess. 1013 (1986) (emphasis added). Thus, when Congress has had occasion to focus on the question, it has made clear that all amounts payable under deferred compensation agreements are to be treated as compensation, and deducted and included by employer and employee at the same time.[7]

Finally, as the court of appeals emphasized (*e.g.*, Pet. App. 13a-16a), allowing petitioner a current deduction for "further sum[s]" accrued under its deferral agreements would undermine the comprehensive scheme that Congress has established to encourage employers to establish and maintain "qualified" plans. The benefits and burdens of qualified plans are carefully calibrated. See pp. 9-10, *supra*; Pet. App. 9a-10a, 13a-15a. Recognition of petitioner's claimed deduction would upset that calibration. As the court of appeals put it, if an employer "could simply retain the funds and receive tax benefits similar to those [it] would receive if those amounts were paid out, there

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[7] Similarly, the explicit reference in Section 457(a) to "income attributable" to amounts deferred under a state or local government's deferred compensation plan (see Pet. 18) merely reflects increased analytical sensitivity to implicit interest issues on the part of the drafters who revised that Section in 1986. Petitioner's reliance (Pet. 22) on Section 467(g) of the present Code, first enacted in 1984, is similarly misplaced; that Section does not apply to "any amount to which section 404 * * * applies." And the fact that Section 267 of the Code prohibits a variety of schemes that would otherwise result, like the analysis of deferred compensation that petitioner urges, in the mismatching of deductions and income in transactions between certain related taxpayers (see Pet. 22) sheds little light on the proper interpretation of Section 404's specific rules regarding all deferred compensation agreements.

would clearly be little incentive to establish a qualified plan." Pet. App. 10a.

Depending on the deferral period and the rate used to calculate additional amounts under a deferred compensation agreement, the "additional" amounts due under such an agreement could, as the court of appeals recognized (Pet. App. 14a), easily exceed the original "basic" amount an employee agreed to defer. The court correctly reasoned that Congress could not have intended to prohibit an employer that maintains a nonqualified deferred compensation plan from deducting the basic amount before actual payment, but to allow a current deduction for what might well be the bulk of the package. *Id.* at 14a-15a. Moreover, because an employer with a qualified plan could deduct only the "basic" amounts actually contributed to a trust for the benefit of plan participants, allowing current deductions for "additional amounts" under nonqualified plans could actually encourage the establishment of nonqualified plans in preference to qualified ones. There is no warrant for rejecting the Commissioner's reasonable construction of the term "compensation" in Section 404, in favor of a theoretical construct that would have the effect of providing similar or even greater tax benefits to a nonqualified plan that discriminates in favor of a few highly compensated individuals and does not require current funding or separate administration to secure the future availability of any part of the benefits promised under the plan.

d. As petitioner acknowledges (Pet. 23), there is no conflict among the courts of appeals about the nondeductibility of any amount payable under a deferred compensation agreement. Indeed, this case appears to be the first one to address the question. Had the

court of appeals accepted petitioner's novel argument, other taxpayers would undoubtedly have attempted to claim similar deductions. The dramatic fiscal implications of that departure from the status quo would have made the decision one of exceptional importance, and might have warranted review even in the absence of a conflict. See generally Pet. App. 100a-102a (government's petition for rehearing below). Because the court of appeals ultimately reached the correct decision, however, its judgment preserves, rather than upsets, the reasonable expectations of both Congress and taxpayers, and threatens no unwarranted depletion of the fisc. Moreover, the retroactive amendment to Section 404 discussed above forecloses petitioner's contention for all taxable years after 1984, and the issue is therefore of limited continuing importance. Under the circumstances, there is no reason for this Court to review the case.

2. a. Section 38 of the Code, as in effect during the taxable year at issue, allowed a credit against tax for a portion of a taxpayer's investment in certain types of "section 38 property." The definition of "section 38 property" included "tangible personal property (other than an air conditioning or heating unit)." 26 U.S.C. 48(a)(1)(A) (1982). Treasury regulations in turn defined "tangible personal property" to include all tangible property except land, buildings and other inherently permanent improvements, and the "structural components" of buildings and similar structures. Treas. Reg. § 1.48-1(c) (1982). The regulations further defined "structural components" to include "all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system. " Treas. Reg. § 1.48-1(e)(2) (1982).

Petitioner nonetheless claims (Pet. 23-26) that it is eligible for the investment tax credit with respect to HVAC systems installed in its grocery stores during the tax year at issue in this case. Petitioner relies entirely (see Pet. 23) on an exception set out in Section 1.48-1(e)(2) of the regulations (*reprinted at* Pet. App. 98a-99a), which provides:

> [T]he term "structural components" does not include machinery the sole justification for the installation of which is the fact that such machinery is required to meet temperature or humidity requirements which are essential for the operation of other machinery or the processing of materials or foodstuffs. Machinery may meet the "sole justification" test provided by the preceding sentence even though it incidentally provides for the comfort of employees, or serves, to an insubstantial degree, areas where such temperature or humidity requirements are not essential. For example, an air conditioning and humidification system installed in a textile plant in order to maintain the temperature or humidity within a narrow optimum range which is critical in processing particular types of yarn or cloth is not included within the term "structural components."

The government has never disputed that the HVAC systems at issue here provided the temperature and humidity necessary for the proper operation of the refrigerated food cases in petitioner's stores. The dispute has centered instead on whether that effect could plausibly have been the "*sole* justification" for installation of those systems in petitioner's retail food stores. The court of appeals correctly held (Pet.

App. 37a-40a) that it could not. As the court pointed out (*id.* at 38a), the HVAC systems played an important role in the essential function of ventilating the supermarkets. In addition, as the court recognized (*id.* at 38a-39a), air conditioning in the summer and heating in the winter provided a comfortable year-round shopping environment for petitioner's customers. It is therefore hardly surprising that, as the court observed (*id.* at 39a), petitioner had installed HVAC systems in most of its stores during the 1950s, well before it was aware of any relationship between those systems and the proper operation of its display cases.

The court of appeals properly concluded that, while maintaining the proper temperature and humidity to operate other equipment might have been one reason for installing HVAC systems, it was not the "sole justification" for installing them within the meaning of the regulations. Pet. App. 40a. Whatever the precise contours of the "sole justification" test, a particular justification cannot be the "sole" one if the HVAC system in question would have been installed in any case, even if that justification had somehow been eliminated.[8] In this case, it is abundantly clear

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[8] The regulations provide that an HVAC system may meet the "sole justification" test even if it "incidentally provides for the comfort of employees." Pet. App. 98a. As the court pointed out (*id.* at 39a-40a), the example given to illustrate that point is a narrow one, involving maintenance of a temperature and humidity range "critical" to the production process in a factory. *Id.* at 98a-99a. The example implies that if the system were not required for the manufacturing process, the taxpayer would not have installed it in any event, simply for the benefit of the factory's employees. The same cannot plausibly be said of an HVAC system that maintains, among other functions, an

that petitioner would have installed air conditioning and heating systems in its retail stores—located from Florida to Idaho—in order to ensure proper ventilation and a comfortable customer environment, *whether or not* those systems were necessary to the operation of any other equipment in its stores. "That is, indeed, little more than common sense." Pet. 24.[9] The decision below is plainly correct, and there is no need to revisit it in this Court.

b. Petitioner argues (Pet. 13-14, 26) that the court of appeals' decision on the investment tax credit issue conflicts with the decision in *Piggly Wiggly Southern, Inc.* v. *Commissioner*, 803 F.2d 1572 (11th Cir. 1986). In *Piggly Wiggly*, the court held that "[t]he 'sole justification' test necessarily involves a factual determination as to why the taxpayer made particular expenditures." *Id.* at 1576. The court refused to "say as a matter of law that a supermarket's sole justification for installing a particular HVAC system could not have been to meet temperature and humidity needs of other equipment." *Ibid.* On the

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attractive and comfortable environment for retail grocery store customers.

[9] Petitioner argues (Pet. 5-6, 23-24, 25-26) that it keeps the temperature in its stores lower than it otherwise would during the summer because of the requirements of its display cases. Even if those requirements provide the "sole justification" for the thermostat setting that petitioner chooses, however, that does not demonstrate that they provide the "sole justification" for having heat or air conditioning in the first place. When the outdoor temperature is over 90 degrees, petitioner's customers might prefer that the indoor temperature be maintained at 78 degrees rather than at 72 degrees, see Pet. App. 74a; but it is difficult to believe that they would prefer (or even tolerate) the absence of any air conditioning at all.

facts of the case before it, the court held that there were "two permissible views of the evidence," and refused to characterize as "clearly erroneous" the Tax Court's "factual findings * * * that Piggly Wiggly chose the particular HVAC system [involved in that case] in order to meet equipment specifications and that customer and worker comfort was an incidental benefit." *Id.* at 1575, 1576.

In this case, applying the same legal standard to similar facts, the court of appeals reached a different factual conclusion. Pet. App. 38a-40a & n.25. One other court has reached the same result as the court below, after an exhaustive examination of the particular facts of the case before it. *Publix Supermarkets, Inc.* v. *United States*, 26 Cl. Ct. 161 (1992). Whatever the merits of *Piggly Wiggly*'s holding on the facts of that case, there is no conflict among the courts on the applicable legal standard; and any variations in the ultimate factual determinations reached in the few cases that have addressed the "sole justification" issue in the supermarket HVAC context do not warrant review by this Court.

Moreover, as petitioner acknowledges (Pet. 14), the investment tax credit was repealed, with limited transitional exceptions, by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 211, 100 Stat. 2166-2170. The repeal of the credit considerably diminishes the importance of the "sole justification" test at issue in this case. As petitioner points out (Pet. 14), the test remains relevant for purposes of determining the availability of certain accelerated depreciation deductions. If it becomes necessary for this Court to consider the meaning or application of the test for those purposes, however, it would surely be preferable to await a case that presents specific issues of

continuing relevance in an appropriate legal and factual context.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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IN THE
Supreme Court of the United States
OCTOBER TERM, 1995

ALBERTSON'S, INC.,
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v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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BRIEF AMICUS CURIAE OF THE CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA IN SUPPORT OF THE PETITIONER

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BRIEF AMICUS CURIAE OF THE CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA IN SUPPORT OF THE PETITIONER

INTEREST OF THE *AMICUS CURIAE* [1]

The Chamber of Commerce of the United States of America supports the Petitioner with respect to Question No. 1 as presented in the Petition: Whether Section 404

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[1] This brief is filed with the written consent of the parties pursuant to Rule 37.3 of this Court's Rules. Letters of consent are being filed simultaneously with the Clerk.

of the Internal Revenue Code bars the current deduction of interest accrued under a nonqualified deferred compensation plan.

The Chamber is a federation of approximately 215,000 companies and several thousand other organizations such as state and local chambers of commerce and trade and professional organizations. It is the largest association of business and professional organizations in the United States.

A significant aspect of the Chamber's activities involves regular representation of the interests of its member-employers before the courts, the Congress, and the Executive Branch of the federal government. The Chamber has sought to advance those interests by filing briefs *amicus curiae* in many cases involving federal income taxation, including *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979) and *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984).

This case presents an important issue of proper interpretation of statutes enacted by Congress—particularly the income tax laws. The Ninth Circuit imposed what it recognized was a non-literal reading of the Internal Revenue Code provisions relating to nonqualified deferred compensation plans. It held that despite statutory language allowing interest accrued under a nonqualified plan to be deducted at the time it accrues, the court would impose a rule allowing deduction only later, when the deferred compensation is actually paid.[2] This non-literal

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[2] Under qualified plans, employers make contributions to trusts (or other investment vehicles) set up by the plan. The contributions are tax deductible to the employer, and neither the contributions themselves nor income those contributions earn in the trust is taxable to the employee until distributed to the employee, generally during retirement. To qualify, a plan must meet exacting criteria, including minimum vesting requirements, prohibition against self-dealing, nondiscrimination in favor of highly paid employees, and others. IRC § 401 (1988); *see* BORIS I. BITTKER

interpretation is not supported by legislative history, but only by the court's version of federal tax policy. The Chamber supports a grant of certiorari because its members generally are subject to federal taxation and need to be able to comprehend the provisions of the tax laws and to make plans and decisions on that basis. Court decisions subjecting taxpayers to non-literal construction of those laws are highly disruptive of those desirable goals. Moreover, many of the Chamber's members use qualified and nonqualified deferred compensation plans, and the Ninth Circuit's holding creates a significant impediment to the usefulness of nonqualified plans to provide for pensions and other forms of deferred compensation for their employees.

REASONS FOR GRANTING CERTIORARI

This brief is addressed solely to the first question presented in the Petition and adopts the statement of the case and the reasons for granting certiorari as stated in the Petition with respect to Question No. 1. That question is an important one deserving review by this Court because of the revenue involved, the widespread use of nonqualified plans, and the severe shortcomings of the Ninth Circuit's approach to statutory construction.

This case presents an important opportunity to consider when it is appropriate for a court to read a statute to

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& LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS ¶¶ 61.1.1, 61.2 (2d ed. 1990).

Nonqualified plans include any deferred compensation plan that does not meet one or more of the requirements of a qualified plan. IRC § 404(a) governs the deductibility of employer contributions to a nonqualified plan. As Professor Bittker points out, while "compensation is ordinarily deductible by an employer using the accrual method when it is earned and the liability arises, Section 404(a) is a "departure from the customary rules of accrual accounting," and under that section the sums paid in compensation are not deductible until actually paid to the employee. BITTKER & LOKKEN, *supra*, ¶ 60.2.2, at p. 60-15. *See* Pet. 21.

impose a greater burden than the plain text of the statute would impose. This Court has held that the literal meaning of a statute must be the pre-eminent guide to its actual meaning and to an understanding of Congress's purpose in enacting it. *E.g., Ardestani v. INS*, 502 U.S. 129, 137 (1991). Policy considerations extraneous to the statutory terms "cannot override [a court's] interpretation of the text" unless such considerations show that a literal reading of the text "would lead to a result so bizarre that Congress could not have intended it." *Demarest v. Manspeaker*, 498 U.S. 184, 191 (1991) (internal quotation omitted). As Judge Easterbrook, speaking for the Seventh Circuit, has put it, "Provisions of the Internal Revenue Code do not conflict with 'tax policy' . . . . They are tax policy and are to be enforced." *Sears, Roebuck and Co. v. Commissioner*, 972 F.2d 858, 868 (7th Cir. 1992).

This Court's holdings appear not to have made any impression on the Ninth Circuit. That court readily recognized both in its original opinion and on rehearing that under the plain and literal text of the Internal Revenue Code accrued interest on the debt of future compensation is "interest" within the meaning of Section 163 and immediately deductible (Pet. App. 16a, 35a). Moreover, that court acknowledged that under a literal reading, a qualified plan provides a tax advantage over nonqualified plans, because under a qualified plan, the actual compenstion paid by the employer is immediately deductible, while under a nonqualified plan it is not deductible until it is actually paid to the employee. Pet. App. 14a. Even as calculated by the Ninth Circuit (which sought to minimize the advantage),[3] this is undeniably a signifi-

[3] The Ninth Circuit calculated that compared to the 100 per cent of the "deferred compensation package" (i.e., actual compensation plus interest) that is deductible by the employer or not chargeable as income to the employer or employee under a qualified plan, only 70 per cent (i.e., interest alone) is deductible to the employer using a nonqualified plan under the facts of this case, which included the

cant tax benefit favoring use of qualified versus nonqualified plans.

An analysis of such factors should have ended the matter for a reviewing court. Under the plain and literal statutory language Congress gave a valuable but not unlimited incentive toward the use of qualified plans. That the incentive is not stronger is not "bizarre." It is a characteristic Congressional choice. Given the typical features of Congressional legislation—the leavening of moderation and compromise, the "balance[s] struck" (*Hallstrom v. Tillamook County*, 493 U.S. 20, 30 (1989), *reh'g denied*, 493 U.S. 1037 (1990)), and the multiple purposes of enactments (*see Toibb v. Radloff*, 501 U.S. 157, 163 (1991))—it is not even surprising. While Congress could have made the disincentive to use nonqualified plans greater, it could also have made it smaller—or provided none at all. It is not a court's role to rethink such legislative questions.

The Ninth Circuit also did not identify any legislative history to support its conclusion that the statute should not be given its plain and literal meaning.[4] In fact, that

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period of deferral for the employees at issue and an accrued interest rate "similar to that used by Albertson's", Pet. App. 14a, which rate the court of appeals had earlier found was "a direct reflection of what Albertson's would have paid on the open market in order to borrow such amounts." Pet. App. 29a-30a.

[4] The Ninth Circuit quoted part of a sentence from the Senate and House Reports favoring enactment of Section 404 stating that in a nonqualified plan if an employer defers payment of "compensation," the employer "will not be allowed a deduction until the year in which the compensation is paid." Pet. App. 11a, quoting from H.R. Rep. No. 2333 and S. Rep. No. 1631, 77th Cong., 2d Sess. (1942), *reprinted* in 1942-2 Cum. Bull. 372, 452, 504, 609. The court of appeals named this the "matching principle."

However, since Section 404 in terms applied that matching requirement only to compensation and not to interest, and since the legislative history did not suggest that this effect be extended beyond compensation itself, it cannot be said, and the Ninth Circuit did not hold, that allowing immediate deductibility of accrued inter-

court recognized in its earlier opinion that there was no pertinent legislative history. Pet. App. 35a. Instead, to support its view that the literal meaning was contrary to tax policy, the court of appeals advanced its own ideas of appropriate taxation, asserting that "it would make little sense" and "reduce the significance of the incentive structure of Section 404" to bar a current tax deduction for compensation in nonqualified plans without also deferring the deduction for interest accrued thereon. Pet. App. 15a, 14a. This misconceived the court's role. Even putting aside the question of whether it was proper to look further than the plain meaning of the statutory terms, "[w]hen . . . nothing in the legislative history remotely suggests a congressional intent contrary to Congress' chosen words . . . any further steps take the courts out of the realm of interpretation and place them in the domain of legislation." *United States v. Locke*, 471 U.S. 84, 96 (1985).

Even though the Ninth Circuit asserted that the purpose that it attributed to Congress of favoring qualified plans would be "thwart[ed]" by the application of the statute's plain meaning, it did not cite any evidence or indication that this was in fact the case, and it appears unlikely that it was.[5]

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est would offend this so-called "principle." Instead the court held that it "would make little sense"—i.e., would offend the court's own sense of proper tax policy—not to *extend* the "principle" to accrued interest. Pet. App. 15a.

[5] For at least 14 years, from 1977 through 1991, one of the most widely read federal income tax services advised that accrued interest on the obligation to pay future compensation under a nonqualified plan was currently deductible. *See* 1977-1990 Stand. Fed. Tax Rep. (CCH) ¶ 2656A.25 and the 1991 edition at ¶ 2657N.056. If there had been a decline in qualified plans in favor of nonqualified plans during this period, that result would likely have been brought to the attention of the court of appeals. It was not. Moreover, since at least some employers use both qualified and nonqualified plans (*see* Arthur H. Kroll, *Deferred Compensation Agreements*, 385-3d Tax Mgmt. (BNA) at A-23 (1994)), it is

Finally, we note that at least as much as in any other area, there is a need in the administration of the law of taxation for statutes to mean what they plainly say. Although the Internal Revenue Code is very complex, yet it must apply throughout the economy of the United States. It must be read and applied by taxpayers in every walk of life and in every business. To the present practice of reading the Code closely to determine its meaning —difficult enough in view of its complexity and length of 1.3 million words—would be added a vague and uncertain process in which taxpayers and their advisers would be forced (1) to determine whether there was some policy that might cause the taxpayer to depart from the plain and literal meaning, (2) to define such a policy, (3) to decide whether the statute or the policy should control—and then (4) to await, for an extended period, a determination of whether the taxpayer had guessed correctly.[6] Recognition of the possibility that tax statutes might be read non-literally (even in the absence of any legislative history to support such a result) would make the taxpayer's obligation to comply with the law much more difficult and would injure or destroy the ability to plan for business transactions or personal decisions (such as retirement). Long-settled arrangements made in complete reliance on the plain meaning of the statutory text could be upset because, as here, a court later decided that the law should mean something other than what it says.

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possible that more favorable treatment for nonqualified plans would lead to greater use of such plans without any decline in the use of qualified plans.

[6] Presumably the government would not look favorably upon any departure from the plain meaning that favored the taxpayer.

CONCLUSION

For the foregoing reasons, as well as those set out in the Petition, the writ of certiorari should be granted.

Respectfully submitted,

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BRIEF *AMICUS CURIAE* OF THE FOOD MARKETING INSTITUTE IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Whether central heating, ventilating, and air-conditioning systems installed in supermarkets to meet the temperature and humidity requirements set by manufacturers of refrigerated food cases constitute "tangible personal property" within the meaning of section 48 of the Internal Revenue Code.

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BRIEF *AMICUS CURIAE* OF THE FOOD MARKETING INSTITUTE IN SUPPORT OF PETITIONER

INTEREST OF *AMICUS CURIAE*

Pursuant to Supreme Court Rule 37, the Food Marketing Institute respectfully submits this brief in support of the petition for writ of certiorari of Petitioner, Albertson's, Inc.[1] The Food Marketing Institute (hereinafter "FMI" or "the Institute") is a nonprofit association that conducts programs in research, education, industry relations and public affairs on behalf of its 1500 members. Its membership consists of food retailers and wholesalers in the United States and worldwide. FMI's domestic members operate approximately 21,000 retail food stores, includ-

[1] Food Marketing Institute has received the written consents of the Petitioner and Respondent to the filing of this brief; those consents have been filed with the Clerk of the Court.

ing large multi-store chains, small regional firms and independent supermarkets, with annual sales volume of $220 billion.

At issue in this case is the tax treatment of central heating, ventilation and air conditioning systems (hereinafter "HVACs") utilized in the retail food industry to maintain strict temperature and humidity control of refrigerated and frozen food display cases. FMI is concerned that the Ninth Circuit's flawed opinion will deny the industry the ability to treat HVACs as "tangible personal property" pursuant to section 48 of the Internal Revenue Code.[2] The inclusion of HVACs within this definition determines whether the investment tax credit is available for such equipment for years prior to 1986 and whether, on a continuing basis, such equipment qualifies for accelerated depreciation under Internal Revenue Code section 168. As an industry uniquely affected by this issue, the Institute's members have a vital interest in the proper disposition of this case.

FACTUAL BACKGROUND

The Ninth Circuit's error was one of regulatory interpretation recast as factual error. A brief recapitulation of the evidence in its proper industry context provides a clearer perspective.

It is axiomatic that a retail business requires customers but, more fundamentally, it requires a product to sell. Retail food establishments, whether a small grocery store or a national supermarket chain, are in the business of selling food. Although non-food products (such as pharmaceuticals or health and beauty care products) also are sold, food sales account for over 70 percent of grocery

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[2] Unless otherwise noted, all section references are to the Internal Revenue Code of 1954, 26 U.S.C., as amended, and all references to regulations are to Treasury regulations promulgated thereunder (26 C.F.R.).

store sales nationally. *See* Food Marketing Institute, Key Industry Facts 1995, p. 7.

What may be less apparent is that perishable foods, and more particularly refrigerated and frozen foods, are the lifeblood of a retail food store. Perishable foods account for $50 of every $100 spent in a supermarket, and items requiring refrigeration, including deli items, meats, fish, dairy products and frozen foods, are the major component of this expenditure. *See* Progressive Grocer Annual Report, April 1995, p. 26. The importance of refrigerated and frozen foods to a grocery store, however, far exceeds their dollar value because consumers frequent grocery stores primarily to purchase such items. As a result, a common marketing strategy of supermarkets is to display such items around the perimeter and/or down the center aisles of a store to encourage the customer to shop the entire store. This display arrangement is familiar to any consumer who has shopped at a grocery store and is a direct consequence of the importance of refrigerated and frozen foods in attracting customers.

It is self-evident that refrigerated and frozen foods require refrigeration to prevent spoilage and package deterioration. Food spoilage is of paramount importance to the food retail industry for reasons of safety, and likewise is a principal concern of store customers. Logic dictates that consumers will not patronize stores whose perishable products show signs of spoilage, irrespective of the quality of other grocery items. Retail food stores rely on refrigerated and frozen food cases (hereinafter "refrigerated cases") to display and preserve foods requiring refrigeration. Several different types of cases are typically used, based on the particular needs of the individual business, and most consumers are familiar with the open-front and closed-door cases used for this purpose.

Refrigeration is a significant expense. The energy costs of a supermarket typically are second only to labor in

relative expense. The operation of refrigerated cases commonly accounts for 50 percent or more of supermarket energy costs. This energy is consumed both in the machine room (containing condensers and compressors) and at the display case (air-circulation fans, anti-condensate heats, lights and defrost systems). *See* Air Conditioning, Heating & Refrigeration News, "Food Industry is Huge Market for Refrigeration Manufacturers," November 14, 1994. Refrigeration costs are particularly critical to a grocery store's profitability because of the highly competitive nature of the industry where net profits typically range from one to two percent. Equally, the loss of its refrigerated and frozen foods to spoilage or deterioration adversely affects inventory costs and profits.

Refrigerated cases, irrespective of type, operate optimally within the confines of temperature and humidity levels set by manufacturer specifications. In Petitioner's case, the manufacturer specifications recommended an ambient store environment at or below 75 degrees Fahrenheit and at or below 55 percent relative humidity. These specifications are those commonly established for refrigerated cases used in the industry. Achieving those specifications is a function both of the refrigerated cases and the HVAC system because of the interaction between a store's environment and the functioning of the cases.

As recognized by the Tax Court below, the quality of food in refrigerated cases can be adversely affected if the ambient temperature in the store is too high, even if the cases are functioning properly, and icing of coils can occur when the relative humidity is too high, which also affects the proper functioning of the cases. App. D at 72a. Indeed, it is no exaggeration to say that the enemy of a supermarket is high humidity. Proper dehumidification translates into less moisture condensation on the cases, a reduced burden on the heaters which prevent condensation from fogging up the cases, reduced burden on the air-conditioning equipment, decreased de-

frost cycles and run-time for the cases, reduced condensation on the evaporator coils and reduced frost build-up or sweating on food products. As the Tax Court discussed specifically in relation to the shelf life of meat products, manufacturers' specifications as to temperature and humidity must be strictly maintained. Even minor variations can cause improper functioning of the cases and food spoilage. App. D at 74a.

Petitioner submitted evidence below that its HVAC systems were installed and designed solely with the operating requirements of its refrigerated cases in mind. For example, the air delivery systems that were part of the HVAC system were designed in a special "T" configuration, which moved air through the stores in a manner that would maintain the conditions necessary to operate the cases efficiently. This design would not be found in HVAC systems used in stores without refrigerated cases. Petitioner also demonstrated that HVAC systems designed for human comfort would not have met its refrigeration requirements. For example, in two instances where Petitioner acquired stores previously used as retail department stores, the existing HVAC systems were replaced with systems designed to meet the requirements of Petitioner's refrigerated cases. In these and other respects, Petitioner demonstrated the unique relationship between its refrigerated cases and HVAC systems. Further affirmation was found in the fact that Petitioner's HVAC system operated 24 hours a day, even when Petitioner's stores were closed to customers. App. D at 80a.

Equally important, the Tax Court rejected as not credible Respondent's expert witness reports that Petitioner had another substantial purpose, namely, employee and customer comfort, for the particular HVAC system deployed. The court stated in this regard that "[w]e do not find respondent's experts persuasive in support of this proposition because many of the authorities relied upon by respondent's experts do not directly support the

expert's conclusion. . . ." App. D at 79a. The court instead found Petitioner's evidence persuasive that the ambient store environment maintained for operation of the refrigerated cases caused the store temperature to be uncomfortably cold to many of its customers. App. D at 80a.

Petitioner's proof was more than adequate to support the Tax Court's factual finding that the regulatory "sole justification" test was satisfied. The correlative effects on ventilation and comfort were understood to be secondary and largely the result of temperature and humidity specifications for the refrigerated cases within levels of human tolerance, if not always optimum human comfort. As articulated by the Tax Court, "[t]he fact that manufacturers may have designed their cases so they could generally be operated in a 'comfortable' ambient environment was an incidental benefit to petitioner." *Id.* The Ninth Circuit's contrary conclusion was not due to clear error by the Tax Court but, rather, the Ninth Circuit's reformulation of the governing legal standard so as to treat the Tax Court's factual findings as largely irrelevant.

SUMMARY OF THE ARGUMENT

The question presented is whether HVACs utilized by Petitioner, a corporation operating several hundred retail grocery and drug stores, are "tangible personal property" within the meaning of Treasury Regulation § 1.48-1 (e)(2) and, therefore, eligible for the investment tax credit or accelerated depreciation. This determination depends on whether the "sole justification" for the installation of the HVAC equipment is that such equipment "is required to meet temperature or humidity requirements which are essential for the operation of other machinery or the processing of materials or foodstuffs," irrespective of whether the equipment "incidentally provides for the comfort of employees, or serves, to an insubstantial degree, areas where such temperature or

humidity requirements are not essential." Reg. § 1.48-1 (e)(2).

This case merits review because the Ninth Circuit, in acknowledged and direct conflict with the Eleventh Circuit in *Piggly Wiggly Southern, Inc. v. Commissioner*, 803 F.2d 1572 (11th Cir. 1986), and with the Tax Court,[3] has adopted an unreasonably restrictive interpretation of the "sole justification" requirement of the regulation. The Ninth Circuit's interpretation effectively prohibits tangible-personal-property treatment of HVAC equipment utilized in the retail food industry for strict temperature and humidity control of refrigerated display cases. The regulation explicitly permits such treatment notwithstanding any incidental collateral effects on ventilation or comfort inherent in the function of such HVAC equipment. However, the Ninth Circuit treats such collateral effects as dispositive evidence of multiple purposes for the installation of the equipment, thereby precluding satisfaction of the "sole justification" requirement. This interpretation impermissibly narrows the scope of the regulation.

For national or regional food chains, the conflict with the Eleventh Circuit and the Tax Court created by this decision will produce significantly differing investment tax credit and depreciation treatment for retail food establishments in close geographical proximity and direct competition based merely on the fortuity of their corporate headquarter locations. Such inequitable results are of fundamental concern to the Institute and its members.

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[3] It is well established that uniformity among the circuits in tax cases is especially important to ensure predictable and equal administration of the federal income tax system. *See, e.g., United States v. Gilbert Assocs., Inc.*, 345 U.S. 361, 364 (1953); *Unger v. Commissioner*, 936 F.2d 1316, 1320 (D.C. Cir. 1991); *Nickell v. Commissioner*, 831 F.2d 1265, 1270 (6th Cir. 1987); *First Charter Fin. Corp. v. United States*, 669 F.2d 1342, 1345 (9th Cir. 1982).

REASON FOR GRANTING WRIT OF CERTIORARI

THE NINTH CIRCUIT MISCONSTRUED THE APPLICABLE LAW AND CREATED A CONFLICT AMONG THE CIRCUITS

The decision of the Ninth Circuit is in direct conflict with the decision of the Eleventh Circuit in *Piggly Wiggly Southern, Inc. v. Commissioner*, 803 F.2d 1572 (11th Cir. 1986), as well as the Tax Court which has twice considered this precise issue. This conflict is the result of an erroneous analysis of the applicable regulatory scheme.

Regulation section 1.48-1(e)(2) generally treats "all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts . . . relating to the operation or maintenance of a building," as "structural components" for which the investment tax credit, for years prior to 1986, is not available. However, the regulatory scheme creates a special exception for:

> machinery the sole justification for the installation of which is the fact that such machinery is required to meet temperature or humidity requirements which are essential for the operation of other machinery or the processing of materials or foodstuffs.

Reg. § 1.48-1(e)(2). The regulation thus makes a critical distinction between HVAC equipment that is a structural component of the operation and maintenance of a building, and HVAC equipment that is installed in response to temperature and humidity requirements of other machinery. On its face, therefore, the regulation contemplates the treatment of HVAC equipment installed precisely for the purpose installed in this case as tangible personal property, rather than as a structural component. The evidence in the record below that Petitioner's equipment was installed for, and essential to, this purpose is uncontroverted.

The regulation further provides that "[m]achinery may meet the 'sole justification' test" "even though it incidentally provides for the comfort of employees, or serves, to an insubstantial degree, areas where such temperature or humidity requirements are not essential." *Id.* The regulation then provides an example which satisfies the regulatory test:

> For example, an air conditioning and humidification system installed in a textile plant in order to maintain the temperature or humidity within a narrow optimum range which is critical in processing particular types of yarn or cloth is not included within the term "structural components."

Id.

Every other court that has considered the question posed in this case has construed the regulation to require a facts-and-circumstances determination which balances the essential justification for the equipment against any corollary benefits that may result. Irrespective of the particular results in each case, this approach has entailed careful attention to the evidence proffered by the parties.

In the only case on all fours with this one, *Piggly Wiggly Southern, Inc. v. Commissioner*, 84 T.C. 739 (1985), *aff'd*, 803 F.2d 1572 (11th Cir. 1986), the Tax Court held for the taxpayer. It accepted the taxpayer's evidence as to the purpose for which the HVAC equipment was installed and rejected Respondent's evidence that the HVAC units were installed to allow the taxpayer to attract customers. The evidence proffered by Respondent was found to be based on generalities and to "err[] in its failure to look at facts relating to petitioner's specific situation." 84 T.C. at 752. Although recognizing that "[t]he operation of the HVAC units indubitably benefited Petitioner's workers and customers," the court concluded that "this was a collateral benefit, incidental to the maintenance of proper environmental conditions for the operation of petitioner's machinery." *Id.* at 753. The court

summarily rejected Respondent's argument to the contrary:

> It is bootstrapping to argue, post hoc ergo propter hoc, that where a collateral benefit necessarily follows an action, that the collateral benefit belies another basis as the justification for the action.

Id.

On appeal, Respondent urged the Eleventh Circuit to reverse for precisely the reason urged upon, and adopted by, the Ninth Circuit in this case, to wit, that "refrigeration equipment requirements could not have been the exclusive justification because Piggly Wiggly needed some type of HVAC equipment for customer and worker comfort in order to remain competitive." 803 F.2d at 1575. The Eleventh Circuit rejected the Commissioner's implicit equation of sole justification with "exclusive justification." The Court explained that the regulation calls for a "balancing of the 'sole justification' versus 'incidental benefits'." *See id.*

In contrast, the Ninth Circuit in this case narrowly interpreted the sole justification test to mean exclusive justification. It substituted the bootstrapping logic decisively rejected by the Eleventh Circuit and the Tax Court for the factual inquiry mandated by the regulation. The decision of the Ninth Circuit thus is diametrically opposed to the regulatory interpretation adopted by the Eleventh Circuit and the Tax Court. As those two courts appreciated, to treat a collateral effect as tantamount to, and dispositive evidence of, a separate purpose for the installation of HVAC equipment effectively eviscerates the regulatory exception for such equipment even when installed for the precise purpose contemplated by the regulation.

Because the Ninth Circuit misconstrued the applicable legal standard, it presupposed factual findings contrary to those made by the Tax Court, specifically, as to the importance and degree of customer comfort (or discomfort)

associated with the operation of Petitioner's HVAC equipment. It is well known, and Petitioner's evidence in this regard was consistent with general experience in the retail food industry, that customers frequently complain of the cold temperatures necessitated by operation of the HVAC equipment to maintain the ambient temperature and humidity environment necessary for proper operation of refrigerated and frozen food cases. An important component of Petitioner's evidence in this regard was a 1979 publication of the Institute entitled "Why Is It So Cold In Here?," which addressed common customer complaints about cold store temperatures. "Unlike other commercial buildings, supermarkets do not base air conditioning on comfort considerations. Rather, air conditioning works together with the refrigerators in keeping perishable foods at proper temperatures." *See* Pet. Ex. 96-CR ("Pet. Ex." refers to Petitioner's trial exhibit). The Tax Court acknowledged the strength of Petitioner's evidence in this regard as to "discomfort to many customers who complained to petitioner's employees that the stores were uncomfortably cold. Nevertheless petitioner could not raise its store temperature to accommodate its customers without risking spoilage of its refrigerated food products displayed in open-front cases." App. D at 74a. Indeed, as Petitioner also demonstrated below, its employees were not permitted to adjust store thermostats or temperatures for comfort-related reasons. Thermostat settings were established and maintained strictly for the operation of the refrigerated cases.

The Ninth Circuit's legal analysis also overlooked facts considered by the Tax Court concerning the role of the ventilation function of the HVAC system in the proper operation of the refrigerated cases. Ventilation is a constituent function of an HVAC system because air must circulate through the system to be properly conditioned in terms of temperature and humidity. The record contains substantial evidence in this regard that ventilation was essential to the proper functioning of Petitioner's refrig-

erated cases. Moreover, Petitioner demonstrated that it had other ventilation systems (not at issue) to serve sanitation and cleanliness purposes. *See* Petition for Rehearing at 6-8.

Finally, the Ninth Circuit's opinion that "during the 1950s, Albertson's had already installed HVAC systems in most of its supermarkets, well before it was aware of any interrelationship between HVAC systems and the proper functioning of its other equipment" is not supported by the record below. App. B at 39a. The Court disregarded evidence in the record that the connection between HVAC systems and the operation of refrigerated cases was known in the industry years before Petitioner's food stores were air-conditioned.[4] (*See* Pet. for Rehearing at 3, 9-11.)

In practical effect, the Ninth Circuit has established a *per se* rule that, as a matter of law, will preclude virtually any HVAC equipment from meeting the regulatory requirements.[5] The Ninth Circuit's reasoning simply cannot be reconciled with the regulation's explicit allowance for the precise types of incidental benefits that are associated with Petitioner's HVAC equipment. Nor can it be reconciled with the example in the regulation. In that example, the air-conditioning and humidification system installed in the textile plant necessarily provided air conditioning to the employees and other occupants of the

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[4] The Court's reference to Petitioner's situation four decades ago is particularly irrelevant because grocery stores in the 1950s did not widely use the open-front refrigerated cases used throughout modern supermarkets today.

[5] The only other court to have addressed this issue, the Court of Federal Claims, also undertook a detailed factual inquiry and distinguished its holding from the decision in *Piggly Wiggly* and the Tax Court's decision in this case on the basis of differences in the proof proffered by the parties. *See Publix Supermarkets, Inc. v. Commissioner*, 26 Cl. Ct. 161 (1992). *See also Circle K Corp. v. Commissioner*, 43 T.C.M. (CCH) 1524 (1982), which the Tax Court distinguished from *Piggly Wiggly* on its facts. *See* 84 T.C. at 752.

textile plant. The regulation clearly states, however, that such corollary benefits do not preclude satisfaction of the governing regulatory standard.

The Ninth Circuit's enfeeblement of the regulation is conclusively demonstrated by the Court's reliance on a comparison of the effects of Petitioner's HVAC system on air quality or comfort with the hypothetical absence of any HVAC system:

> [W]e find it impossible to say that air conditioning during the summer and heating during the winter does not result in a more comfortable shopping environment for the taxpayer's customers.

App. B at 39a. It may well be that, in some cases, taxpayers will be unable to carry their burden of proving that, as a factual matter, their HVAC systems meet the "sole justification" test when weighed against the incidental effects of the system. But the issue cannot be settled by the sweeping generalization that effects on comfort or ventilation are inherently more than "incidental" in all cases where taxpayers would otherwise heat, ventilate or air-condition their buildings. Such an interpretation renders the regulatory exception created for this precise type of HVAC equipment a virtual nullity.

The Ninth Circuit incorrectly read the regulation to allow employee comfort but not customer comfort. The Court's exclusion of customer comfort from the incidental effects permitted by the regulation categorically excludes an entire class of HVAC equipment from treatment as tangible personal property based merely on the category of end user, *i.e.*, a retail business. Rationally construed, the regulation's focus on employee comfort cannot be taken so literally. It merely reflects the regulation's discussion of equipment used in an industrial context. More importantly, the fundamental distinction created by the statutory and regulatory framework generally, and in relation to HVACs particularly, is between (i) structural components that are an integral part of a building's op-

eration and maintenance and (ii) tangible personal property essential to, and installed for, the operation of equipment. Petitioner's HVAC system must be evaluated in light of, and solely by reference to, this basic distinction.

The distinction is important not only for purposes of the investment tax credit for years prior to 1986. The availability of accelerated depreciation turns on the same distinction. HVAC systems treated as "structural components" of a building are subject to straight-line depreciation over more than a 30-year period. By contrast, if treated as "tangible personal property", accelerated depreciation over a shorter five-year period is available. *See* Prop. Treas. Reg. § 1.168-3(c); Reg. § 1.1245-3(c)(2). The continuing effect of the Ninth Circuit's flawed interpretation of the "sole justification" test is another reason to grant certiorari in this case.

CONCLUSION

The decision in this case holds that an HVAC system installed and operated to maintain the temperature and humidity requirements of other equipment cannot satisfy the "sole justification" test because secondary effects of its operation are inherently not incidental. The Ninth Circuit's decision in this respect is contrary to the explicit regulatory exception created for HVAC equipment installed for this purpose, is inconsistent with the required facts-and-circumstances inquiry into the taxpayer's intent in installing and operating the equipment, and, in practical effect, eviscerates the regulatory exception. It has infected the treatment of HVAC systems in the retail food industry with considerable uncertainty for purposes of the investment tax credit and accelerated depreciation and creates an acknowledged and direct conflict with the Eleventh Circuit and the Tax Court. For these reasons, the amicus respectfully urges that the Court grant the Petition for Writ of Certiorari.

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No. 94-1796

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IN THE
Supreme Court of the United States
OCTOBER TERM, 1994

ALBERTSON'S, INC.,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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BRIEF OF AMICI CURIAE, CONNECTICUT MUTUAL LIFE INSURANCE COMPANY, NEW ENGLAND MUTUAL LIFE INSURANCE COMPANY, STANDARD INSURANCE COMPANY AND STATE MUTUAL LIFE ASSURANCE COMPANY OF AMERICA IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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INTEREST OF AMICI CURIAE

Pursuant to Rule 37.2 of the Rules of the Supreme Court of the United States, *amici curiae*, Connecticut Mutual Life Insurance Company, New England Mutual Life Insurance Company, Northwestern Mutual Life Insurance Company, Standard Insurance Company, and State Mutual Life

Assurance Company of America file this joint brief in support of the petition for writ of certiorari filed by Albertson's, Inc. on the first question presented, relating to the federal income tax treatment of interest on deferred compensation.[1]

Petitioner's case involves the deductibility of interest credited under elective, nonqualified deferred compensation arrangements that covered certain of Petitioner's key executives and one of its directors. In considering the petition for writ of certiorari, this Court should be aware that American businesses, including *amici*, commonly make use of elective, nonqualified deferred compensation arrangements. This Court should also be aware that many elective deferred compensation arrangements are not limited solely to a company's executives and directors. Many arrangements, including those of *amici* as discussed below, cover independent contractors who are not part of the management of the businesses for which they provide services.

Amici are life insurance companies engaged in the business of selling life insurance, annuity, and other insurance contracts. As is typical in the life insurance industry, *amici* rely on the services of a large network of geographically dispersed insurance agents who are independent contractors. The contracts *amici* enter into with their insurance agents prescribe the total compensation to be paid such agents for insurance product sales and related

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[1] Petitioner and Respondent, through their counsel, have consented to the filing of this brief in letters filed with the Clerk of this Court. *Amici* express no views on the second question presented, arising under section 48 of the Internal Revenue Code ("Code"). Unless otherwise indicated, section references herein are to the Code, 26 U.S.C., as in effect for Petitioner's tax year in question (ending February 3, 1983).

services rendered. Under these contracts, the agents are compensated for their services on the basis of a fixed percentage of first-year and renewal premiums received in respect of insurance policies sold by such agents.

As is also common in the life insurance industry, *amici* have for many years maintained elective deferred compensation arrangements similar to those at issue here with agents who wish to participate in such arrangements. In fact, basic tax law relating to nonqualified deferred compensation was established in *Commissioner v. Oates*, 207 F.2d 711 (7th Cir. 1953), *aff'g* 18 T.C. 570 (1952), by a life insurance agent who decided to defer receiving commissions pursuant to an elective arrangement under which such commissions, plus interest, were credited over a period of years to a bookkeeping account maintained in his name.

The elective deferred compensation arrangements maintained by *amici* simply allow insurance agents to defer until a future date the receipt of compensation they earn upon performing services. The amount of compensation deferred and the period of deferral are selected by the agent. Prior to the payment date, the deferred amount is retained by *amici* and is available for corporate use. *Amici* keep track of the deferred amounts through bookkeeping accounts maintained for each agent. The deferred compensation arrangement is no more than an unfunded, unsecured promise — *i.e.*, a debt owed — by *amici* to pay an agent's compensation in the future.

In return for having the use of the deferred compensation for which *amici* are indebted, *amici* credit interest to the bookkeeping accounts maintained in the names of the agents for the period during which such compensation is deferred. Interest is first credited to such an account only after a

specified period of time has elapsed (*e.g.*, a month) since the deferred compensation was earned and credited to such account. Interest is also credited thereafter with the passage of time (*e.g.*, on a monthly basis). In short, interest credited under elective deferred compensation arrangements is a function of the passage of time, the amount in the account, and the applicable interest rate. It is not a function of services performed.

Therefore, as is also true in Petitioner's case, the compensation for services rendered by the agents of *amici* and the interest credited under their deferred compensation agreements are separate and distinct items. There is no relationship between the total compensation payable for services rendered by the agents and the interest credited under the deferred compensation agreements. The interest reflects the time value of the use by *amici*, and the forbearance of use by the agents, of the compensation deferred by the agents. There is no reason for the amount of compensation for services rendered by the agents to increase as a result of the deferral of the payment for such services. The services are not worth more simply because the payment for them is delayed.[2] There is, however, a sound reason for adding interest to the deferred amounts: as a result of services performed by their agents, *amici* are indebted to them for the compensation that is deferred and have the use of the compensation so deferred during the deferral period.

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[2] Indeed, it would be a violation of New York insurance law (which effectively sets nationwide limits on sales expenses for those life insurance companies doing business in New York) to compensate life insurance agents by paying them additional compensation that is disguised as interest. *See* N.Y. Ins. Law § 4228 (McKinney 1985).

Amici, like other companies taxed on the basis of accrual accounting both within and without the life insurance industry, have long been deducting when accrued the interest credited under their elective deferred compensation arrangements. Thus, Petitioner's treatment of the interest at issue is by no means unique. For many years, the Commissioner of Internal Revenue (the "Commissioner") raised no question with respect to the current deduction of accrued interest credited under elective deferred compensation arrangements. Indeed, prior to litigating the present case, the Commissioner never officially announced that it is her position that such interest is not currently deductible.[3] More recently, on audit of the tax returns of several *amici*, the Commissioner disallowed the claimed deduction of such accrued interest. One *amicus* now has a related issue in litigation.[4]

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[3] The Commissioner did issue several unofficial and nonprecedential pronouncements on the question, which did not contain authoritative support or meaningful analysis. *See, e.g.*, Priv. Ltr. Rul. 8619006 (Jan. 30, 1986), a technical advice memorandum which was issued to Petitioner in this case and which merely concluded that the amounts characterized as "interest" by Petitioner "appear to be more appropriately classified as additional compensation subject to section 404(a)(5) of the Code."

[4] *New England Mut. Life Ins. Co. v. United States*, No. 92-257T (Ct. Fed. Cl. filed Apr. 9, 1992). This case involves the tax characterization of "interest" accrued on deferred compensation obligations to independent contractors. Because the tax years involved in this case precede the date when the statutory provisions at issue in Petitioner's case were extended to arrangements involving independent contractors, the litigation involving *amicus* raises the question of whether the interest credited on deferred compensation obligations is "interest on indebtedness" for tax purposes. For later tax years, all the issues raised by Petitioner's case are also applicable to *amicus*.

In sum, the decision in this case with respect to interest on deferred compensation is of direct and substantial interest to *amici*, as well as other employers.

SUMMARY OF ARGUMENT

The Court of Appeals, *by its own admission*, disregarded the language of the Internal Revenue Code and took it upon itself to rewrite the statutory provisions in question on the basis of "policy" views that cannot demonstrably be attributed to Congress. The substantive tax issue raised has potentially broad applicability, and has significant import to taxpayers as well as to the federal fisc. Review of this issue by this Court is therefore warranted.

ARGUMENT

The issue in this case of interest to *amici* is whether the deduction of interest accrued on nonqualified deferred compensation obligations is governed by normal tax principles for interest deductions, as Petitioner argues, or by the timing rules of sections 404(a)(5) and 404(d) of the Code, as the Commissioner contends.

Section 404(a)(5) (governing deferred compensation arrangements with employees) and section 404(d) (governing such arrangements with independent contractors) set forth in specific and unambiguous terms the category of deductions to which the timing rules of those provisions apply. Those sections state in relevant part that "compensation," accrued under a plan deferring its receipt, is to be deductible for the taxable year in which it is includible in the gross income of the individuals participating in the plan. Those provisions make no reference to "interest." Further, for the tax years in question, those provisions expressly applied only to "compensation" that satisfied the conditions of section 162

(for deducting business expenses) or section 212 (for deducting an individual's expenses for the production of income). Those references reinforced that "interest," which is deductible under section 163 rather than section 162 or section 212, is beyond the scope of section 404.

In deciding the case below, the Court of Appeals agreed with Petitioner that section 404 by its terms did not apply to Petitioner's deduction for "interest":

> [U]nder a literal reading of the statutory language, the deduction of interest is not affected by section 404.

Pet. App. at 16a. Nonetheless, the court resolved this issue against Petitioner on the basis of tax policy considerations urged by the Commissioner, for which the court found a basis primarily in the views of certain commentators[5] rather than in the language or legislative history of the Internal Revenue Code. Pet. App. at 10a-17a. The Court of Appeals concluded:

> *[D]espite the literal wording of the statute*, Congress could not have intended to exclude interest payments, a substantial part of the deferred compensation package, from the rule prohibiting deductions until such time as the employee receives the benefits.

Pet. App. at 18a (emphasis added).

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[5] In the petition for writ of certiorari at 17, Petitioner has noted other commentators who supported the decision for Petitioner initially rendered below by the Court of Appeals.

There are special and important reasons for this Court's review of this decision on writ of certiorari. The Court of Appeals did not resort to "policy" concerns to interpret an ambiguous statute. The Court of Appeals did not subordinate the language of the Code to an articulated contrary expression of Congressional intent. Rather, in a singularly bald example of judicial legislation, the Court of Appeals explicitly disregarded the literal terms of the Code in favor of purported policy considerations that were not and cannot be demonstrably ascribed to Congress. Pet. App. at 10a-18a.

It is axiomatic that "[u]nder our constitutional framework, federal courts do not sit as councils of revision, empowered to rewrite legislation in accord with their own conceptions of prudent public policy." *United States v. Rutherford*, 442 U.S. 544, 555 (1979). Adherence to statutory language is particularly important in tax cases. The Internal Revenue Code is replete with formal rules and fine distinctions, reflecting refined tax theory in some instances and political compromise in other instances. The language of the Code cannot be contrary to tax policy; it *is* tax policy, and must be respected.

The effort of the Court of Appeals to ascertain for itself the proper "policy" conclusion misdirected that court's decision. The key policy conclusion on which that court relied is that a "matching principle" should apply to deductions for interest with respect to deferred compensation, in order to avoid an incentive for taxpayers to adopt these arrangements rather than tax-qualified retirement plans (*i.e.*, plans qualified under section 401(a) of the Code). Pet. App. at 11a-12a. Section 404 requires such "matching" with respect to deferred compensation for services. With respect to interest accrued on deferred compensation,

however, the tax "policy" of "matching" simply cannot be attributed to the Code or to Congress.

A "matching" principle is not inherent in the overall structure of the Code. To the contrary, under basic tax law principles, some taxpayers may determine their income tax on a cash basis of accounting, and other taxpayers may determine their income tax on an accrual basis. *See* Code section 446(c). Under this system, "mismatches" between an accrual-basis debtor's interest deduction and a cash-basis creditor's recognition of interest income necessarily will occur. In specific circumstances, Congress has affirmatively required "matching" with respect to interest. *See*, *e.g.*, sections 163(b), 267(a)(2), and 467 of the Code as currently in effect; *compare* sections 163(e)(1) and 1272(a)(1) of the Code as currently in effect. Section 404 states no such requirement.

Furthermore, a "matching" principle is not indispensable to Congressional efforts to encourage tax-qualified retirement plans. Qualified plans enjoy a number of important tax advantages unavailable to (nonqualified) deferred compensation arrangements. For example, contributions to qualified plans are immediately deductible, favorable tax rules may apply to qualified plan distributions (including beneficial income-averaging treatment and tax-free rollovers), and benefits provided by qualified plans are "funded" and protected from creditors.[6] Congress could rationally have concluded that those advantages sufficed to provide any intended incentive in favor of qualified plans, regardless of the deductibility of interest accruals under deferred compensation arrangements. The decision below is

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[6] *See* sections 401(a), 401(a)(2), 402(c), 402(d), 404(a)(1) of the Code as currently in effect.

wholly unsupported by any evidence of a legislative calculus rejecting the sufficiency of these other advantages.

In addition, in their capacity as providers of retirement arrangements, *amici* can attest that they and many other employers have not and would not abandon their qualified plans, as the Court of Appeals suggested, if interest accruals under deferred compensation arrangements are deductible. The foregoing advantages of, as well as the business purposes served by, qualified plans assure their continued use. Many taxpayers must provide retirement benefits to attract and retain employees and, because non-management employees generally cannot be covered by nonqualified deferred compensation arrangements,[7] these taxpayers effectively must maintain tax-qualified retirement plans. Conversely, some taxpayers may enter into deferred compensation arrangements with independent contractors, for whom such taxpayers may not permissibly maintain tax-qualified retirement plans because such plans may cover only common-law employees and certain statutory employees.[8] The policy considerations on which the appellate court relied are irrelevant to these taxpayers.

This case therefore is not like *Bob Jones University v. United States*, 461 U.S. 574 (1983), or *United States v. American Trucking Ass'ns*, 310 U.S. 534 (1940), on which the Court of Appeals relied. The language of section 404 is

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[7] Because of the interplay between the Code and the labor law title of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), 29 U.S.C. §1001 *et seq.* (1995), nonqualified deferred compensation plans must generally be limited to management or highly compensated employees and to independent contractors.

[8] *See* sections 401(a), 414(n), and 7701(a)(20) of the Code as currently in effect.

not plainly at variance with the purposes of that provision. Congress could reasonably have intended the outcome required by the statutory language of section 404, and that language therefore must be enforced.

The Commissioner routinely argues for adherence to the literal language of the Code where tax revenue would be enlarged. *See, e.g., Commissioner v. Soliman*, ___ U.S. ___, 113 S. Ct. 701 (1993); *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992). In her petition for rehearing before the Court of Appeals, the Commissioner estimated that tax revenues of up to $7 billion could be lost in Fiscal Years 1994 through 1999 if Petitioner's position is sustained. App. Pet. at 101a. It is shocking that, if the Commissioner's estimate is correct, she proposes to collect $7 billion in taxes *beyond that authorized by Congress in the language of the Code*.

In sum, the Court of Appeals *admittedly* substituted its own (and dubious) tax policy conclusions for a result required by the language of the Code and supportable under the purposes of the relevant statutory provisions. "Courts are not authorized to rewrite a statute because they might deem its effects susceptible of improvement." *Badaracco v. Commissioner*, 464 U.S. 386, 398 (1984). This issue involves both jurisprudential considerations of broad significance, and substantive tax considerations of meaningful import to taxpayers and the federal fisc. This issue therefore warrants this Court's review.

CONCLUSION

For the foregoing reasons, this Court should grant the petition for writ of certiorari.

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REPLY BRIEF

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1995

No. 94-1796

ALBERTSON'S, INC.,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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REPLY BRIEF

In opposing the grant of certiorari, respondent does not dispute the importance of this case. Instead, she argues that the questions presented were correctly decided by the Ninth Circuit and thus need not be considered by this Court. Whether the decision below was correct, however, is a matter that the Court can only determine upon plenary review. Such review should be granted and the decision below reversed, for respondent's arguments on the merits, as the Court will find, are insubstantial.

1. *Section 404 does not bar the current deduction of accrued interest under a nonqualified deferred compensation plan.* The first question presented "affects just about every nonqualified deferred compensation plan in the country." Tom Herman, *U.S. Appeals Court Overturns its Ruling in High-Stakes Tax Case*, Wall St. J., Dec. 6, 1994, at B12. Respondent herself has conceded that because "more than 60% of the Fortune 500 utilize non-

qualified deferred compensation plans . . . [and] [t]he use of such plans is not limited to major corporations," this question "is one of exceptional importance to the administration of the federal income tax laws" and the case is one "of major fiscal importance." App. H at 101a, 102a.

a. Respondent now suggests that the case's "dramatic fiscal implications" derived only from the Ninth Circuit's initial decision, which she describes as a "departure from the status quo." Br. in Opp. 21. Respondent claims that the court's subsequent decision on rehearing "preserves the reasonable expectations of both Congress and taxpayers." *Id.* Respondent has it backwards. In all of the long legislative history of section 404 and its statutory predecessors, respondent is unable to point to even a single instance, and petitioner has found none, in which Congress, a Congressional committee, or even an individual Congressman has stated that the current deduction of accrued interest is barred. Taxpayers themselves, reading the plain language of the statute, reasonably understood that a current deduction is allowed. Even the Ninth Circuit acknowledged that a current deduction would be allowed under "the literal wording of the statute." App. A at 18a.

The status quo, as reflected in Commerce Clearing House's Standard Federal Tax Reporter since 1977, was the widely accepted view that section 404 does *not* bar the current deduction of accrued interest. *See* Pet. 20. As respondent implies, Br. in Opp. 14-15 n.6, petitioner was less alert than some other taxpayers to the availability of this deduction. *See e.g.*, Brief of *Amici Curiae* Connecticut Mutual Life Insurance Company *et al.* (*amici* "have long been deducting when accrued the interest credited under their elective deferred compensation arrangements"). But in 1982, when petitioner did request permission to change its method of accounting to claim the deduction, the Internal Revenue Service granted permission with alacrity. App. C at 45a.

This case arose only because "[i]n 1987, the IRS changed its policy." App. A at 3a. It was that change in respondent's policy, and the Ninth Circuit's own about-face on rehearing, that marked a radical departure from the status quo. As a result, the decision on rehearing now threatens to throw billions of taxpayer dollars—at least $7 billion according to respondent, App. H at 101a—into the tax litigation maelstrom. This Court should grant review to short-circuit that process.

b. As her principal reason why review should be denied, respondent argues that irrespective of the scope of section 404, the amounts petitioner seeks to deduct do not constitute "interest . . . on indebtedness" within the meaning of section 163. Br. in Opp. 11-15. That argument was accepted as the basis for decision in the Tax Court, but it was rejected not only by nine members of that court (four concurring and five dissenting judges) but also by all three members of the appellate panel. In its initial opinion, the Ninth Circuit explained at length and in detail why the amounts do indeed constitute "interest . . . on indebtedness" under section 163. *See* App. B at 29a-32a. On rehearing, the court did not deviate from that position, instead taking pains to disassociate itself from "the reasons upon which the Tax Court majority relied." App. A at 7a. Based upon its own (and respondent's) unsupported notion of what constitutes appropriate tax policy under section 404, the Ninth Circuit on rehearing reasoned that although "under a literal reading of the statutory language, the deduction of *interest* is not affected by section 404," *id.* at 16a (emphasis added), "Congress could not have intended to exclude *interest* payments . . . from the rule prohibiting deductions until such time as the employee receives the benefits." *Id.* at 18a (emphasis added). The court obviously rejected respondent's claim that the amounts at issue do not constitute interest.

Although the Ninth Circuit ultimately erred in its construction of section 404, it was correct in its characterization of the amounts as "interest . . . on indebtedness"

within the meaning of section 163. Under its deferred compensation agreements, petitioner became indebted to participants to the extent of the compensation for personal services that they had elected to defer; the agreements explicitly provided for accrual of interest on that indebtedness at an objectively determined market rate of interest. *See* App. C at 42a. Those accruals constitute garden variety "interest . . . on indebtedness" falling well within the scope of the deduction afforded by section 163. *See Starker v. United States*, 602 F.2d 1341, 1356 (9th Cir. 1979). All respondent's arguments to the contrary were carefully considered and fully answered by a total of 12 judges below, *see* App. B at 29a-32a; App. C at 61a, 65a-66a, and it is not necessary to beat that dead horse any further here.

Respondent nonetheless asserts that her "contextual interpretation is plainly reasonable, and . . . is entitled to deference from the courts." Br. in Opp. 15. That is pure bootstrapping. Respondent's "contextual interpretation" cannot be found in any regulation under either section 163 or section 404; it is no more than respondent's litigating position in this case. As such, it is entitled to no more deference than any other litigant's position. Moreover, in attempting elsewhere to explain why section 457 explicitly refers to both compensation and interest whereas section 404 refers only to compensation, respondent argues that by 1986 when it enacted section 457 Congress had acquired an "increased analytical sensitivity to implicit interest issues." Br. in Opp. 19 n.7. This argument not only overlooks the fact that section 404 itself was amended in 1986 but also reveals that respondent herself knows full well, notwithstanding her lengthy protestations to the contrary, that the amounts at issue do indeed constitute interest.

c. Turning at last to the real question of statutory construction presented by this case, respondent claims the Ninth Circuit found that "the recognition of immediate deductions [for accrued interest] would be inconsistent

with the terms and purpose of Section 404." Br. in Opp. 16. That is an obvious overstatement. Even on rehearing, the Ninth Circuit expressly, and correctly, recognized that the "plain language" and "literal wording of the statute" or, in respondent's words, "the terms" of section 404, allow the current deduction of accrued interest. App. A at 18a. By its terms, section 404 postpones the deduction only of "compensation," not "interest." In contrast, section 267, which also concerns payments between accrual basis and cash basis taxpayers and whose predecessor was first enacted in the Revenue Act of 1937, Pub. L. No. 377, 50 Stat. 813, 827, always has separately identified both "expenses" and "interest." Even at the time the predecessor of section 404 was enacted, therefore, Congress fully appreciated the difference between "interest" and other expenses such as "compensation" and would not have used the latter term when it meant to refer to the former. *See also* sections 457(a) and 3121 (v)(2)(B) (distinguishing, in the context of deferred compensation plans, between "compensation" or "wages," on one hand, and "income attributable thereto," on the other).

Recognizing the deliberately narrow reach of section 404, respondent's own regulations have long and consistently made clear that the exclusive focus of the statute is on "compensation for personal services actually rendered." Treas. Reg. § 1.404(a)-1(b) (1983). *See also* Temp. Treas. Reg. § 1.404(a)-1T, Q&A-1 (as amended by T.D. 8435, 1992-2 C.B. 324). Indeed, the regulations provide an example of the operation of section 404 which necessarily implies that accrued interest, unlike deferred compensation, is immediately deductible in the year of accrual. *See* App. C at 68a-69a. Ironically, respondent now argues that "[t]here is no warrant for rejecting the Commissioner's reasonable construction of the term 'compensation' in Section 404." Br. in Opp. 20. But the only construction deserving of deference is the one contained in the regulations, not the revisionist position taken in re-

spondent's litigation briefs, and those regulations support petitioner, not respondent.

d. In the end, respondent, like the Ninth Circuit, falls back on the following policy-driven syllogism: in enacting section 404, Congress evidently sought to make qualified plans more attractive than nonqualified plans; to accomplish this result, section 404 requires the employer's deduction for "compensation" to be matched against the employee's recognition of income; extending this "matching principle" to "interest" as well as "compensation" would further enhance the relative attractiveness of qualified plans; to advance the perceived congressional purpose, therefore, one should read the word "compensation" in section 404 (although nowhere else in the entire Internal Revenue Code) to include "interest." *See* Br. in Opp. 16-20; App. A at 10a-13a.

This syllogism confuses judicial responsibility for statutory construction with legislative responsibility for tax policy. The proper role of a court is simply to determine on the basis of the statutory text what Congress actually has done, not to extrapolate from that text to other things Congress could or arguably should have done. In section 404, Congress chose to postpone the deduction only of "compensation"; it chose to leave the treatment of "interest" to section 163. Those choices, and those choices alone, define the tax policy relevant to and controlling in this case. *See Sears, Roebuck and Co. v. Commissioner*, 972 F.2d 858, 868 (7th Cir. 1992) ("Provisions of the Internal Revenue code do not conflict with 'tax policy' . . . . They are tax policy.").

The very different tax policy that the Ninth Circuit adopted instead—a policy that cannot be discerned from either the statutory text or the legislative history—has no grounding in the real world of business either. Both respondent and the Ninth Circuit claim that it is necessary to disallow the current deduction of accrued interest under nonqualified plans to avoid discouraging the estab-

lishment of qualified plans, *see* Br. in Opp. 20, but that is demonstrably wrong. Qualified plans retain numerous tax and other advantages; nonqualified plans, whose effective scope (notwithstanding respondent's suggestion to the contrary, *see* Br. in Opp. 10) is narrowly restricted by the Employee Retirement Income Security Act of 1974, 29 U.S.C. §§ 1051(a), 1081(a)(3), and 1101 (a)(1) (1995), cannot be substituted willy-nilly for qualified plans. *See* Brief of *Amici Curiae* Connecticut Mutual Life Insurance Company *et al.* 9-10; Brief *Amicus Curiae* of the Chamber of Commerce of the United States of America 6 n.5.

e. Finally, respondent contends that the 1986 amendment to section 404, which the Senate Report aptly described as a mere "clarification," *see* Pet. 19, "forecloses petitioner's contention for all taxable years after 1984." Br. in Opp. 21. Even the Ninth Circuit knew better than that. *See* App. B at 36a. Both before and after the amendment, the word "compensation" stands as the critical term in the statute, and the proper interpretation of that term remains the core focus of statutory construction. *Id.*; *see also* Pet. 19-20. If, as respondent's parting shot implies, petitioner is correct about the proper reading of section 404 prior to 1986, *a fortiori* petitioner also is correct about the proper reading of the virtually identically worded statute that has been in effect since then.

2. *Supermarket HVAC systems constitute "tangible personal property" within the meaning of Section 48.* The regulatory "sole justification" test that distinguishes "tangible personal property" from "structural components" looks centrally at whether the systems are "*required* to meet temperature or humidity requirements which are essential for the operation of other machinery." Treas. Reg. § 1.48-1(e)(2) (1983) (emphasis added). Respondent concedes that "petitioner's retail food stores *require* HVAC systems to keep ambient store temperatures within case manufacturers' specifications." App. D at 79a (emphasis added). *See also* Br. in Opp. 22. In

other words, petitioner must install HVAC systems in its stores, whether or not those systems may also produce collateral benefits. Such systems therefore constitute "tangible personal property" eligible for the investment tax credit and accelerated depreciation.

a. Respondent nevertheless argues that petitioner's HVAC systems fail as a matter of law to pass the regulatory "sole justification" test because they "played an important role in the essential function of ventilating the supermarkets" and "petitioner had installed HVAC systems in most of its stores during the 1950s, well before it was aware of any relationship between those systems and the proper operation of its display cases." Br. in Opp. 23. Those statements are contradicted by the record. As is common in supermarkets, petitioner's stores have fans and other equipment, separate from the HVAC systems, that provide the necessary ventilation. *See* Tr. 584-86, 589. The relationship between air-conditioning and the proper operation of refrigeration equipment, moreover, was known even before supermarkets generally became air-conditioned, Cmr. Ex. EF, and petitioner was forced to install HVAC systems, even in cool climates, because in the absence of air-conditioning and humidity control its refrigerated cases "were continually icing and causing us all sorts of maintenance problems." Tr. 394.

Nonetheless, the Ninth Circuit unquestionably did base its decision upon the presumed collateral benefits of ventilation and customer comfort. App. B at 38a-39a. Respondent, like the Ninth Circuit, treats such collateral benefits as dispositive and irrefutable evidence of multiple motivations for installing an HVAC system, thereby precluding satisfaction of the regulatory "sole justification" test. This implies that no retail food store, and indeed no retail establishment of any kind, will ever be able to satisfy that test. The Tax Court and the Eleventh Circuit disagree. Those courts take note that the regulation itself explains, through an example, that the "sole justification" test may be met notwithstanding the existence of

other collateral benefits; accordingly, those courts hold that the phrase "sole justification" takes its true meaning from the regulatory context and does not exclude the possibility that the installation of HVAC systems might also be justified on other grounds. *See Piggly Wiggly Southern, Inc. v. Commissioner*, 803 F.2d 1572, 1575 (11th Cir. 1986); App. D at 78a-81a.

Respondent does not contend, nor could she, that this case and *Piggly Wiggly* are factually distinguishable. Both courts below knew that they are not. *See* App. B at 40a n.25; App. D at 78a-79a. The disparate outcomes in *Piggly Wiggly* and this case obviously stem, *pace* respondent, from a "conflict among the courts on the applicable legal standard." Br. in Opp. 25; *see also* Brief *Amicus Curiae* of the Food Marketing Institute 9-10. The Eleventh Circuit and the Tax Court understand that Treas. Reg. § 1.48-1(e)(2) calls for a "balancing of the 'sole justification' versus 'incidental benefits.'" *Piggly Wiggly*, 803 F.2d at 1575. In contrast, the Ninth Circuit holds that the very existence of incidental benefits (except, perhaps, when the only beneficiaries are employees) precludes a finding of "sole justification." App. B at 38a-39a.

For all the usual reasons, this conflict between the circuits should be resolved. There is an added reason to do so here. The settled practice of the Tax Court is to adhere to its own precedent "in cases appealable to courts whose views have not yet been expressed." *Golsen v. Commissioner*, 54 T.C. 742, 757 (1970), *aff'd*, 445 F.2d 785 (10th Cir.), *cert. denied*, 404 U.S. 940 (1971). As owners of retail food stores continue to contest respondent's position and take their cases to the Tax Court, respondent will be forced to litigate in yet other circuits. However those circuits rule, the existing conflict will be broadened and perpetuated.

b. Indulging in hyperbole, respondent argues that the repeal of the investment tax credit "considerably diminishes" the importance of the regulatory "sole justification"

test. Br. in Opp. 25. The test still controls whether taxpayers may take 200 percent declining balance depreciation over a five-year recovery period or, instead, are restricted to straight-line depreciation over a 39-year period. *Id.; see also* Pet. 14-15. This is a distinction with enormous and continuing revenue implications.

c. Finally, although she necessarily is aware that the legal issue under Treas. Reg. § 1.48-1(e)(2) is precisely the same whether the taxpayer is claiming an investment tax credit or accelerated depreciation, respondent suggests that the Court should decide the issue in a case involving accelerated depreciation. Br. in Opp. 25-26. Petitioner has no quarrel with that. This very case presents the issue in the context of both the investment tax credit and accelerated depreciation. *See* App. D at 76a; *see also* Stip. of Facts ¶¶ 92, 98-133 (stipulating that petitioner will be entitled to accelerated depreciation "should this Court hold that the HVAC systems are 'tangible personal property' " and specifying the amounts of the additional depreciation deductions that will be available). Accordingly, this case is fully appropriate for review even under the standard proposed by respondent.

For the reasons stated here and in the petition for writ of certiorari, the petition should be granted.

Respectfully submitted,

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